

THE NEW YORK
Certified Public Accountant

EMANUEL SAXE, *Managing Editor*

EDITORIAL BOARD

RAYMOND G. ANKERS, *Chairman*

JOSEPH A. DOWLING
GEORGE N. FARRAND
MITCHELL FASTOW
RICHARD S. HELSTEIN

WILLIAM C. KNAUF
COLIN I. PARK
SAMUEL J. SHERMAN
REUBEN WESTERMAN

VOL. XXVI

September • 1956

No. 9

• The President's Page—Arthur B. Foye, C.P.A.	525
• State Insurance Departments' Examinations of a Life Insurance Company— Edward J. Mallon, C.P.A.	527
• Internal Auditing as Applied in a Life Insurance Company— Thomas Burgess, Jr., C.P.A.	531
• Audit of a Life Insurance Company by Independent Certified Public Accountants—Henry S. Chapin, C.P.A.	537
• Accounting Aspects of Real Estate Syndicates—Leo H. Seitelman, C.P.A.	543
• Income Tax Aspects of Real Estate Syndicates—Leo Spandorf, C.P.A.	551
• J. Lee Nicholson—The Committee on History	558
• Departments—	
An Adirondack View—Leonard Houghton, C.P.A.	516
Book Reviews	518
New York State Tax Forum—Benjamin Harrow, C.P.A.	560
Accounting at the S.E.C.—Louis H. Rappaport, C.P.A.	561
Office and Staff Management—Max Block, C.P.A.	563
Payroll Tax Notes—Samuel S. Ress	565

Society and Editorial Offices: 677 Fifth Avenue, New York 22, N. Y.
(Copyright, 1956, by The New York State Society of Certified Public Accountants)

AN ADIRONDACK VIEW

Pine Pond would be a "lake" anywhere else in the state. To get there we take our Penn Yan, and 5-horse outboard, and head up the river from the boathouse in our backyard.

The route takes us up through Lake Flower, by Frying Pan Rock and Turtle Island, past Villa Vera, past Otter Slide, then half way through Miller Pond. There we turn south, slow down, watch for stumps, try to avoid lily pads, and finally find the unmarked little channel that leads to a white birch tree where there is a very muddy landing place.

Then a mile walk through the woods and we come to Pine Pond—a little gem back away from the roar and litter of civilization (a question mark after "civilization"). The pond is fed only by little and clear-water streams. Its outlet is evidently underground through water-carrying sand that feeds distant springs. Its beach is long, moderately sloping, and made of sand that is almost white. Its water invites you with persistent silence to come in and swim.

You walk the beach and look at the marks in the sand to see what news they bring. The hoof-print of a deer; dried turtle eggs and the cupped-shaped hole where it is probable that a skunk found a meal; a big foot-

print with toes where a bear came for a walk and a drink. There is so much to see that office cares and family worries are forgotten.

Do you have a Pine Pond in your life? Every certified public accountant needs one.

LEONARD HOUGHTON, CPA
Saranac Lake Branch of
the "Adirondack Chapter."

APPRAISALS

NATIONAL ORGANIZATION OF APPRAISAL ENGINEERS

STANDARD APPRAISAL COMPANY

PITTSBURGH
BOSTON
PHILADELPHIA

6 CHURCH STREET
NEW YORK, N. Y.

ATLANTA
CHICAGO
ST. LOUIS

MAJESTIC Factors CORP.

175 Fifth Avenue at 23rd Street
Flatiron Building New York
OREgon 4-1200

Recommended by Accountants, Banks,
Attorneys and Clients

Officers and Executives

JULIUS N. MESHBERG

EDWARD W. GINSBURG

SIDNEY W. DORMAN

SEYMOUR I. LEBOWITZ

Members of Association Commercial Discount Companies, Inc.
and New York Credit and Financial Management Association

OBSOLESCENCE—A BOOBY TRAP FOR YOUR CLIENTS?

Not with a NINTH FEDERAL "Live" Reserve Account! Competition won't catch your client if he can compete "cash wise" when replacement time comes for things that wear out. Urge him to balance out that depreciation factor by saving a specific sum regularly each month, quarter, or year.

The longer he continues the higher his rate of return: In four years his money will have earned 3%+1/4% per year; in seven and one half years 3%+1/2%; in ten and one half years 3%+3/4%; and in thirteen and one half years 3%+1%. Corporate accounts welcome.

These are examples of NINTH FEDERAL'S "SAVINGS+PLUS" features. There are 13 of them, all explained in Free Booklet CP-7.



3%
Per Year from
July 1, '56

Funds received by
the 10th of the
month earn 3% di-
vidends from the 1st.

NINTH FEDERAL SAVINGS AND LOAN ASSOCIATION



ACCOUNTS
INSURED TO
\$10,000
RESOURCES
OVER
\$75,000,000

TIMES SQUARE: 1457 Broadway UNITED NATIONS PLAZA at 45th St. BURNSIDE at WALTON AVES. BROOKLYN

Hours: 9 to 3; Friday, 9 to 6

Hours: 9 to 3; Wednesday, 9 to 7

Hours: 9 to 3; Monday, 9 to 8

WISCONSIN 7-9120

WELLINGTON 3-3034



THE INDUSTRY THAT SERVES ALL INDUSTRY



**"Nationals save us \$60,000 a year...
return 50% annually on the investment."**

—KOPPERS COMPANY, INC., Pittsburgh

"We use National Accounting Machines on Payroll Writing; Accounts Payable; Accounts Receivable; Sales Analysis by Product; Cost Analysis, Cost Reports and other financial statements; Stores Disbursement Distribution; and Cost Ledgers and General Ledgers.

"We estimate that these Nationals save us \$60,000 a year, returning us 50% annually on the investment. Another advantage is that simplicity of operation and automatic features make it easy to train operators."

Vice President,
Finance

In your business, too, National machines will pay for themselves with the money they save, then continue savings as annual profit. Your nearby National man will gladly show you how. Or write to us at Dayton 9, Ohio.

TRADE MARK REG. U. S. PAT. OFF.

National

ACCOUNTING MACHINES
ADDING MACHINES - CASH REGISTERS

THE NATIONAL CASH REGISTER COMPANY, DAYTON 9, OHIO
989 OFFICES IN 94 COUNTRIES

**FOREMOST NAME
in COMMERCIAL
FINANCE**

JONES
EXPANSION LOANS
CHATTEL MORTGAGES
INVENTORY LOANS
ACCOUNTS RECEIVABLE FINANCING

Do your clients seek the best finance plan, tailored to their individual requirements? For immediate action consult a Jones expert or write for booklet "Using Money to Make Money"

**JONES
and Company**

Specialists in Commercial Finance
Since 1938

292 Madison Avenue, N. Y. 17
Telephone MURray Hill 3-3500

Book Reviews

The Accounting Process

By Edward J. Kelly. FEARON PUBLISHED
San Francisco 15, California, 1956. Pages
xvi + 458; \$6.00.

There are two facets to this book, each of which will be considered separately.

The first point is that the author's approach to the subject of accounting is economic and stems from the writings of John B. Cannan and Irving Fisher. One either accepts the theories of these authorities or disagrees with them; therefore the reviewer will not enter into a controversial discussion of their merits.

The second aspect of the work is that it is offered for beginning students in college courses in accounting. The basic premise is that if the student understands the theory of accounts there is little necessity for demonstrating the mechanical recording of transactions. The success or failure of this theory will depend to a great extent on the enthusiasm and ability of the instructor. The author recognizes this fact in the Preface where he says, "The book should be studied by the student and taught by the instructor."

FRANK A. DUNN

New York, N. Y.

The Theory and Technique of Cost Accounting in the Hosiery Industry

By A. Weyman Patrick. Michigan Business Studies, Volume XII, No. 3. BUREAU OF BUSINESS RESEARCH, University of Michigan, School of Business Administration, Ann Arbor, Michigan, 1956. Pages: ix + 225; \$2.50.

This study is a comprehensive discussion of the problems encountered in the hosiery industry in determining the manufacturing cost per unit of product and in the development of techniques by which these problems can be solved. The author recommends the use of standard costs and has given particular attention to setting standards for yarn usage, direct labor, burden, and loss on imperfect material. The reasons for, analysis of, and uses to be made of variations from standard have been emphasized and a statistical method has been developed for determining the significance of standards. Attention is also given to the cost sheet and to internal reporting. Visits to industrial plants, interviews and correspondence with business executives, and assistance provided by the National Association of Hosiery Manufacturers and the Southern Hosiery Manufacturers Association provided a source of practical information for this study.

Time for a FRESH Approach?



If your clients are worried about rising clerical costs, increasing competition and manpower shortages, it may be time for a fresh approach. That's when you can count on **STATISTICAL** for help.

For those who have their own tabulating department, **STATISTICAL** makes available the experience and facilities of this oldest and largest independent punched-card tabulating service bureau—to supplement your clients' staff and equipment. Often just an "outside" slant can prove invaluable, or the problem may be answered by the latest mechanical equipment maintained here.

On the other hand, if your clients are not using automatic methods now, **STATISTICAL** service can make the latest tabulating techniques available *without increasing clients' overhead*. (If they are planning to install tabulating equipment, we'll be glad to help you show them how.)

Our methods engineers are ready to work with you in providing the service required. Just phone or write us today.

Statistical

TABULATING COMPANY

Established 1933 • Michael R. Notaro, President

80 Broad Street, WHitehall 3-8383

Chicago • New York • St. Louis • Newark • Cleveland

stc

TABULATING
CALCULATING
TYPING
TEMPORARY
OFFICE PERSONNEL

A TRANSFACE FIRST!

Form 941

Employer's Quarterly Federal Tax Return

Now available in Translucency

PRINTED IN

TRANSFACE

*By Special Permission Int.
Rev. Service in lieu of Rev.
Rule 55-573 Sept. 12, 1955*

WRITE FOR SAMPLE AND SPECIFICATIONS
FOR REPRODUCTION TO

TRANSFACE PROCESS CO.
333 Hudson St., New York 13, N.Y.
Telephone: WAtkins 4-5985-6

941 A—CONTINUATION ALSO AVAILABLE

Cagen
Personnel
Agency

Accountants
Controllers
Office Managers
Bookkeepers

509 Fifth Avenue
New York 17, N. Y.
Murray Hill 7-3250

Robert Half
PERSONNEL AGENCIES

130 West 42 Street, N. Y. C.
LOngacre 4-3834

• branch office
• 25-15 Queens Plaza

Directed by a Certified Public Accountant

LAMINATE

- * Education Department Registration Card
- * TREASURY CARD
- * Any Other WALLET size CARD

(FOREVER SEALED IN EVERLASTING PLASTIC)

50 Cents per card

(Enclose remittance . . . coin or stamps)

1 DAY MAIL SERVICE

While You Wait . . . over the counter

PLAQUES made of CERTIFICATES and DIPLOMAS

IDENTIFICATION SERVICE CORP.

144 W. 46th St., N. Y. C. JUDson 2-4725

BLADES & MACAULAY INSURANCE ADVISERS



*Complete Surveys of
Corporate Insurance Affairs
No Insurance Sold*

744 BROAD STREET NEWARK 2, N. J.
Established 1926

BOOKKEEPERS UNLIMITED INC. AGENCY

DIRECTED BY A C. P. A.

RESPONSIBLE
EXPERIENCED
BOOKKEEPING
PERSONNEL
EXCLUSIVELY

299 MADISON AVE., NEW YORK 17
TELEPHONE: OXFORD 7-2237

Major Medical

EXPENSE INSURANCE

- Now available at favorable rates to eligible members of the New York State Society of Certified Public Accountants.
- Dependents of members insured for Hospital and Surgical benefits may also be included for the Major Medical Expense feature.
- Brochures describing the many outstanding features of the N. Y. Society's official Group Accident & Sickness Insurance Plan available on request from

HERBERT L. JAMISON & CO.

Brokers for Society's Group Insurance Plan

270 MADISON AVENUE, NEW YORK 16 • MURRAY HILL 9-1104

COLUMBIA UNIVERSITY

INSTITUTE OF ACCOUNTING

Qualified men and women, graduates of high school or more advanced education, are eligible for this program of instruction affording a background of accounting and other phases of business and industry, as well as preparation for CPA examinations. Day and evening courses; full and part time programs arranged.

Registration Friday, September 21st, through Wednesday, September 26th, 10 a. m. to 8 p. m.; Saturday 9 a. m. to Noon. Low Memorial Library, 116th Street between Broadway and Amsterdam Avenue, New York 27.

COLUMBIA UNIVERSITY

ACCOUNTS RECEIVABLE LOANS

A unique Service for those of your clients who can profitably use additional Working Capital in their business



**LOWEST RATES •
• NON-NOTIFICATION**



Service Factors Company

450 7th Avenue M. Jolles
New York City La 4-7661-2

serving your clients over 20 years

Directed by a C.P.A.

The Accountants & Auditors Agency

15 East 40th Street
New York 17, N. Y.
Murray Hill 3-0290

*The
Employment Agency
Exclusively for
Accounting
Personnel*

Certified Public Accountants
Senior Accountants
Junior Accountants
Supervising Seniors
Cost Accountants
Internal Auditors
Payroll Auditors
Accounting Clerks
Tax Accountants
Budget Directors
Field Auditors
Systems Men
Controllers
Treasurers

BUSINESS AND PERSONNEL OPPORTUNITIES

Help Wanted: 20¢ a word, minimum \$5.00
Situations Wanted: 10¢ a word, minimum \$2.00
Business Opportunities: 15¢ a word, minimum \$3.00
Box number, if used, counts as three words.
Closing Date—15th of month preceding date of publication.

HELP WANTED

Seniors, Semi-seniors and Juniors for our permanent staff. Replies will be held confidential pending interview. Jackson & Zaenglein, 31 Exchange St., Rochester, N. Y.

RESTAURANT CHAIN CONTROLLER — Full charge accounting and controls. Well-known New York City restaurant chain. Must be good administrator. Give full details background, experience and salary. All replies confidential. Box 1023, New York C.P.A.

Top Senior and Semi-Senior Accountant required by progressive C.P.A. firm. Also excellent opportunity for accountant with I.C.C. motor carrier experience. Box 1024, New York C.P.A.

BUSINESS OPPORTUNITIES

Mail and Telephone Service: Desk provided for interviewing. \$6.00 per month, Directory Listing. Modern Business Service, 505 Fifth Avenue (42nd Street).

Attention Mr. Accountant

Save Time, Money and Energy!

TAX RETURNS REPRODUCED in Form Acceptable by Federal and State. **REPORTS TYPED** Accurately and Attractively! Thoroughly checked. LILLIAN SAPADIN, 501 Fifth Avenue, Murray Hill 2-5346.

INVESTMENT INFORMATION

JUSTIN JACOBS

DIgby 4-7140

Statistical Typing

IBM TYPOGRAPHY, Offset Printing. Gisham's, 480 Lexington Avenue, N. Y. 17 PLaza 5-6432.

Office for Rent, Lindenhurst, L. I. Rare opportunity for C.P.A. Beautiful offices in Shopping Center, 800 car parking. Call Kar —Turner 8-1683.

C.P.A., 30, member State Society, excellent background, partnership calibre, seeks association leading to partnership. Present employer will supply data on request. Box 1018, New York C.P.A.

(Continued on page 523)

BUSINESS OPPORTUNITIES (Cont'd)

(Continued from page 522)

C.P.A., own account, desires space in C.P.A. office, east mid-town preferred. Box 1020, New York C.P.A.

C.P.A. desires to purchase accounts or small practice. Cash available. Will be able to close deal immediately. Box 1021, New York C.P.A.

C.P.A. EXAMINATIONS CANDIDATES—private coaching—C.P.A. PROBLEMS—all types or special types—cost, consolidations, municipals etc. Box 1027, New York C.P.A.

Accountant, C.P.A., Society member, wide experience, capable managing practice overburdened accountant desires association offering partnership. Can relocate. Box 1028, New York C.P.A.

Accountant wanted to share office in dignified CPA suite. Statistical typing, steno services. Suitable for single practitioner. Box 1029, New York C.P.A.

C.P.A., 42, modest practice, seeks association or partnership with another established practitioner. Box 1030, New York C.P.A.

SITUATIONS WANTED

C.P.A., age 40, 20 years public experience in all phases of accounting, with emphasis on institutions, nonprofits, fund raising, hospitals, investments, funds, real estate. Seeking part-time or per diem work. Box 1022, New York C.P.A.

Immediately Available

Accounting & Bookkeeping Personnel
"Bookkeepers & Accountants Agency"
130 W. 42 St., N.Y.C.—Call LOnacre 4-1740.

C.P.A.—Attorney, Society member, eight years experience, including heavy tax experience, seeks per diem work. Box 1025, New York C.P.A.

TAX ACCOUNTANT—C.P.A. 15 years, basically Income Taxes; thorough public accounting background; seeks Tax Department connection; public or private, \$7,000. Box 1026, New York C.P.A.

NEED HELP?

"I can help you secure
Dependable
Hard-to-get
Personnel"



Wm. Schnuer, BBA, MBA
Licensee

FIFTEEN YEARS of DEPENDABLE SERVICE to ACCOUNTANTS and THEIR CLIENTS

- COMPTROLLERS
- OFFICE MANAGERS
- ACCOUNTANTS
- C.P.A.'s
- Seniors, Semi-Srs.
- Juniors
- EXECUTIVES
- BOOKKEEPERS
- Full Charge Assistants
- SECRETARIES
- STENOGRAPHERS
- TYPISTS
- CLERKS

PROMPT SERVICE

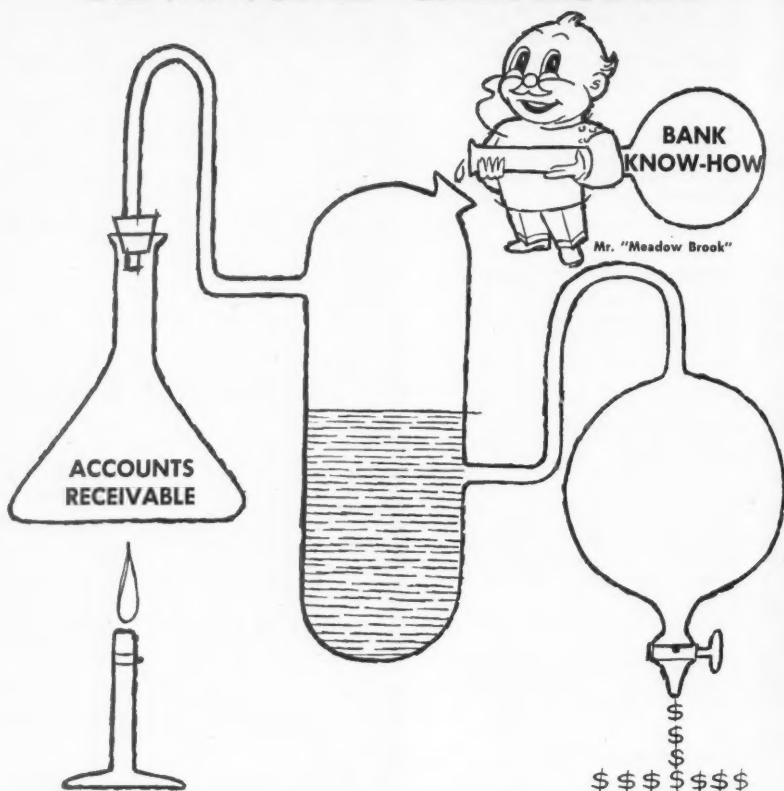
Wm. Schnuer
Licensee

Shirley Schnuer
Licensee

Call
BR 9-
7664

Dependable
EMPLOYMENT AGENCY
220 W. 42nd St. • New York 36

FINANCIAL CHEMISTRY



Mr. Meadow Brook is enabling more and more businessmen to change a **"SOLID"** part of their working capital, their accounts receivable, into **"LIQUID"** cash and here's how.

This is accomplished through our revolving credit plan on Accounts Receivable or Inventory Loans.

Information can be obtained by calling at any of our 25 conveniently located offices in Nassau County or by telephoning IVanhoe 1-9000.

the
MEADOW BROOK
national bank

West Hempstead Office

MEMBER FEDERAL DEPOSIT INSURANCE CORPORATION

THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

VOL. XXVI

September • 1956

No. 9

The President's Page

Forthcoming Legislative Activities

The month of September brings us to the period of most intense activity of the Society. The four months to December 31st are filled with special and general meetings and committee activities and technical meetings to a much greater extent than the months from January to April. The latter are traditionally, (but perhaps only theoretically), the "busy season" for accountants. What do we hope to accomplish in these next four months? What are the major goals of the Society in this period?

Preparation for legislative activity is one of them. It is now sixty years since the enactment of the first legislation in New York State dealing with the profession of accountancy and it is not surprising that, with the growth in numbers and importance of the accountants, few of the intervening years have passed without some phase of the subject having been under active discussion. This year changes were made in the law to broaden the interstate recognition of certified public accountants.

The subject of "regulatory" legislation has had the attention of the Society for many years. Studies have been made and polls of the members taken. Today there is renewed interest

in it. The American Institute of Accountants at its last Council meeting voted to abandon its position of neutrality on regulatory legislation and instructed its Committee on State Legislation to prepare a statement of principles to govern regulatory legislation. This is to be brought before the Institute meeting of members in Seattle this month.

The long awaited report of the Commission on Standards of Education and Experience was finally issued last month and will furnish material for thoughtful consideration and discussion affecting regulatory legislation.

The Board of Regents of the State Department of Education instructed the Council on Accountancy to study the subject of regulatory legislation.

Your own Board of Directors and your Committee on State Legislation have actively considered the matter. The National Society of Public Accountants, the Empire State Association of Public Accountants, Inc., and the Government Accountants Society are also all deeply interested in the subject.

It seems inevitable, therefore, that the subject will be in the forefront of discussion this fall. It is most desirable that the members of the Society think

The President's Page

about and talk about it. In this way if it is reviewed in meetings, and if another poll is taken, all will be sufficiently interested and informed to take a position on it—so that out of the united thinking of the members sound and wise action may be taken.

- There are other goals: improved human relations, wider and better public relations, sounder educational rela-

tions, continued membership growth, technical and ethical standards, closer relations with the American Institute of Accountants and the other State Societies. Some of these we shall discuss in later issues.

ARTHUR B. FOYE,

President.



Sta
of

By Et

This
com

In l
vention
and S
able I
Insura
a most
mentin
more
us, me
sion, t
which
ment's

I b
most s
every
join hi
lieve i
This m
answer
be foll
other p

The
with it
changes
resulted

Edw
past C
Insura
the M
C.P.A
ham U
lege (I
of the
pany

This
Mallon
of the
ence c
and S

State Insurance Departments' Examinations of a Life Insurance Company

By EDWARD J. MALLON, C.P.A.

This paper reviews the highlights of the examination of a life insurance company which is conducted periodically by a State Insurance Department.

In bringing his greetings to this convention of the Insurance Accounting and Statistical Association, the Honorable Leffert Holz, Superintendent of Insurance of New York State, included a most pertinent recommendation. Commenting on the difficulties of examining more and larger companies, he urged us, members of the accounting profession, to help. Have we any techniques which will help to shorten the Department's examination?

I believe the Superintendent was most sincere in his plea. I believe every insurance commissioner would join him in soliciting our help. I believe it is up to us to give answer. This meeting may be the start of the answer. I sincerely hope that it will be followed up by the I.A.S.A. and other professional accounting societies.

The life insurance industry continues with its rapid growth and its many changes. Tremendous increases have resulted in both volume and assets.

EDWARD J. MALLON, C.P.A., is a past Chairman of the Committee on Insurance and Agency Accounting of the New York State Society of C.P.A.s. He is a graduate of Fordham University (B.S.) and City College (M.B.A.). He is the Controller of the Guardian Life Insurance Company of America.

This paper was presented by Mr. Mallon on May 23, 1956, at a session of the Thirty-fourth Annual Conference of the Insurance Accountants and Statistical Association.

Lines of business and investments have been extended and diversified. The range of the changes made is indicated by the present utilization of huge electronic equipment.

Your attendance at this convention of the Insurance Accounting and Statistical Association is your recognition of this growth—of these many changes. You are inspecting machines which a few years ago were not on the drawing boards. You are observing procedures which a few months ago were not in existence. You are here at this session because your own company's growth, the many procedural changes, the new machines, all may have made your audit procedures of a few years ago inadequate or unrealistic today.

General Background

As a company grows in size, its management is forced to delegate some of its duties. This is fundamental. However, sometimes we lose sight of the implications of this delegation. Management is never relieved of strict control over such duties. It must continue this control. The first step in maintaining it is to set up an organization chart. The particular responsibility of each part of management is indicated on this chart.

The second step is to draft procedures and to establish internal check over the various business transactions.

The third step is to have a group of trained personnel observe the organization, review the procedures, test the transactions and internal checks, and report back to management. They re-

State Insurance Departments' Examinations

port the situation and evaluate it with an opinion as to any desirable action which should be taken.

The prime value of the audit procedures lies in this third step.

Later we will hear from two other certified public accountants, members of the New York State Society of CPAs. They will comment on the review undertaken at the request of management. Before we do so, however, we should consider a review which management receives whether it wants it or not—the Insurance Departments' audits. This consideration will help us determine not only the value of the Insurance Department examinations, but also the value of the services of an internal audit staff and an independent public accountant. What is the purpose of the Insurance Department's examination? What doesn't it do?

State Insurance Departments' Examination

Who Makes the Examination?

The laws of almost every state¹ contain a provision that audits of life insurance companies must be made periodically. If every state were to send its audit representative to the home office of each company doing business within the state, there would be chaos. Instead, through the efforts of the National Association of Insurance Commissioners, the country has been divided into 6 zones. Each of these zones represents a certain number of states. Usually the company under examination is visited only by representatives of its own state and five other representatives.

Scope of Examination

Examinations of life insurance companies are made every three years. Desk

audits are made more frequently and will be discussed later. During the triennial examination the coverage is very broad. Assets are closely examined. Securities are physically counted and their values verified. Other assets are checked to make certain that the most conservative values are assigned. Liabilities are scrutinized with the same care. In New York State and other states, bureaus staffed with actuaries have been established to review the policy reserves, which constitute the greatest portion of the company's liability.

In addition to the examination of the balance sheet and transactions, the state auditors review the administration of the business, types of coverage, internal check, treatment of policyholders, etc.²

General Principles

In the course of examination, a state examiner is guided by certain principles in establishing the financial condition of the insurance company. In general, he is guided by sound accounting principles, but specifically he must ascertain³

1. That all assets shown by the books and in the statement as having been on hand at the examination date were actually on hand.

2. Whether any other assets not on the books or not shown in the statement should have been on hand.

3. Whether or not the assets so shown were properly valued in accordance with the Insurance Law.

4. That the liabilities shown by the books and statement at the examination date were actual liabilities.

5. Whether or not all liabilities were in fact shown by the books and statement.

¹ New York State Insurance Law, para. 28.

² Examination of Insurance Companies—N. Y. State Insurance Dept., Vol. 5, pp. 552-579.

³ *Idem*, Vol. 2, p. 141.

State Insurance Departments' Examinations

6. Whether or not the liabilities so shown were properly incurred and established in accordance with the Insurance Law.

7. That the surplus, income, and disbursement accounts were properly stated in accordance with statement requirements.

Aim of State Insurance Departments' Examinations

The purpose of the state Insurance Department examination is not limited to just a financial review. This financial review is not neglected, but the protection of the public by the examiner extends to other matters. The aims may be summarized⁴ to include the following:

1. Determine financial condition and weed out those insurers no longer entitled to public confidence.

a) Perceive any condition which might lead to subsequent financial difficulty.

b) Make appropriate recommendations for remedial action by management.

2. Determine whether insurer is complying to provisions of all laws to which it is subject.

3. Determine whether Board of Directors is properly exercising duties of management.

a) Meetings held at prescribed times.

b) Reasonably regular attendance by individual members.

c) Adoption of proper rules for safeguard of corporate funds.

d) Authorization and approval of investment transactions, as required by law.

e) Establishment of proper rules for general welfare and safety of the corporation.

4. Analysis of claim settlements and treatment of policyholders generally.

a) Sampling of closed and resisted claims.

b) Scrutiny of dividend methods.

c) Identification of questionable claim practices and instances of failure to treat policyholders and claimants fairly and equitably.

5. Review rate making.

6. Uniform allocation of expenses.

Report

At the conclusion of the triennial examination a comprehensive report is made to the Superintendent of Insurance of the home state and to the chairmen of the other zones. This report narrates the audit steps taken, the findings, and the recommendations. By law in New York State⁵, a copy is required to be furnished to each member of the company's Board of Directors, and a summary must be read at the first meeting of the Board after receipt of the report.

Desk Audits

Companies are required to file annual statements to the Insurance Departments. In New York State⁶ and in other states, the Insurance Law requires that the statement be verified by the oath of at least two principal officers of the insurance company, that it show the condition of the company as of December 31, and that it be filed by the following March 1.

⁴ *Idem*, Vol. 2, XXII.

⁵ N. Y. State Insurance Law, para. 31.

⁶ *Idem*, para. 26.

State Insurance Departments' Examinations

The insurance company must file these reports on forms prescribed by the Superintendent of Insurance. The blanks used are those developed by the National Association of Insurance Commissioners. In addition to this annual statement, New York State requires statements for the other quarters of the year.

The statements contain a great deal of information in addition to the financial report. They are reviewed by the various Insurance Departments. The examination is quite thorough and the Insurance Departments do not hesitate to write in for additional information.

What It Is Not

After reviewing all the foregoing and drawing upon our own experience, I believe that we will all agree that the audit by the Insurance Department is thorough and necessary. Life insurance has established such a lofty place for security that none of us want any company to fail its policyholders. One of the means of insuring this is for the state, representing the policyholders, to review the position of the insurance company. Management actually benefits from the review. However, as men-

tioned earlier, management is not relieved of the responsibility for its own strict control over its duties. It must always be remembered that Management, and not the state, is managing the company. Speaking of one aspect of this responsibility, Mr. Heidman, Senior Insurance Examiner, said

"The need for detailed cash audits still remains, but it is a function of sound management, and provision for it should be made either by continuous internal audit or by outside firms engaged for the purpose; it is not a function of examinations carried on by the Department."⁷

Again stressing that the state examination never is intended to replace management's responsibility, we cite a sentence from Superintendent Pink's report to the N. Y. State Legislature⁸

"The solvency of companies, *their honest and intelligent management*, and ability and inclination to meet their obligations as they occur, is of primary importance to the public." (Emphasis supplied.)

How can management—forced by the huge burden of its responsibility to delegate work—still assure "sound management", "honest and intelligent management"? The following speakers will review two of the methods used by management to solve this problem.

⁷ Examination of Insurance Companies, *supra*, Vol. 2, p. 457.

⁸ *Idem*, Vol. 2, p. XXI.



Internal Auditing as Applied in a Life Insurance Company

By THOMAS BURGESS, JR., C.P.A.

This paper discusses the more important elements of the never-ending self-examination of a life insurance company which is conducted continuously by its own internal auditing staff.

How many of you have tried to commit to paper the philosophy of fundamental concepts of internal auditing as applied in your particular companies or as you think they are or should be applied? Sounds easy doesn't it? But I suggest you try it sometime, and I think you will be amazed at the difficulties you encounter. I will even go so far as to say that if five people in your company—and it makes little difference how thorough their respective auditing backgrounds are or what level of organization they fit into—set down their ideas on this subject independently of each other, you are likely to have five sets of quite divergent thoughts. But there will be an undertone of similarity. If you then carefully examine the different sets of thoughts, I think you will find that the basic concepts are actually very similar. The order of importance may be quite

different, and there will be a decided difference of opinion as to the best words and method of expressing these thoughts.

I think we will all agree on one thing, namely, that the fundamental purpose of internal auditing, regardless of the type of organization where applied, is similar. The emphasis, obviously, will vary considerably. I don't expect anyone here to agree with me in every detail—I am sure that very few in my own company will be in complete agreement in all respects—but I shall try to set forth some of the fundamental concepts of internal auditing as I believe they might well be applied in a typical life insurance company.

Over-all Objective

"The basic purpose of all internal auditing is the rendering of a useful service to all members of management—operating, as well as financial."¹ This could be the basic purpose of many other departments or divisions. Could we not say the same for the planning and methods and procedures group and also for those in charge of personnel?

I submit that our over-all objective is to assist management in establishing and maintaining an adequate system of internal control for the safeguarding of the company's assets and the efficient administration of its operations. If I stopped right here, I think many of you would agree with me; however, there

THOMAS BURGESS, JR., C.P.A., is a member of our Society and of its Accounting Machinery Committee. He is also a member of the American Institute of Accountants and the Institute of Internal Auditors. He is Auditor of The Mutual Life Insurance Company of New York.

This paper was presented by Mr. Burgess on May 23, 1956, at a session of the Thirty-fourth Annual Conference of the Insurance Accountants and Statistical Association.

¹"Ten Fundamental Concepts of Internal Auditing." *The Internal Auditor*, Sept., 1955, p. 37.

Internal Auditing as Applied in a Life Insurance Company

would be varying interpretations, and some of you would probably disagree. For example, you might question that part of this statement dealing with "the efficient administration of its operations." We could take sides on this and argue far into the night, and we might both be right. My point here is that we continually stress the importance of an *adequate* system of internal control and we want controls not only to discover errors that have been made but sufficient controls to limit the *possibility* of errors, both intentional and unintentional ones, to a practical minimum. To my mind, this is a definite part of efficient operations, a part where internal auditing can perform an integral and worthwhile role.

The main difficulty with attempting to define internal auditing is that it is a live, fluctuating, pulsating doctrine. In one instance, it may have rather narrow application or limits; in another, its limits may be almost infinite. I prefer to think of the internal auditor as an integral member of the over-all team. On a baseball team, each member has his primary responsibilities. But one player alone cannot make a winning team. Every member is important and must cooperate with the others. Take the shortstop and the third baseman, for instance. Each knows the area for which he is primarily responsible. On one grounder hit in the general direction of the "hot corner," the third baseman will go for the ball and the shortstop will back him up. In a slightly different situation, the shortstop will go for the grounder with the full understanding that, if he fails, his third baseman teammate will be backing him up. In the case of a fly ball, they must use their own good judgment and decide between themselves and without hesitation who will make the

play and who will stand by ready to help, if help is needed.

In business, too, our primary responsibilities must be clear. But for successful operation, there must be teamwork. There are times when we need no help, when it is not necessary for us to help the other fellow, when we can operate efficiently within the bounds of our normal recognized authority and responsibility. However, we must always be ready to help our associates or to request assistance from them. As with a team sport, it is a matter of exercising good judgment; we must be constantly alert to what is best for the company as a whole. Therefore, I say that internal auditing to be of maximum value must remain flexible; and I think we will create problems for ourselves if we try to specifically define its limits, to do more than lay down its broad responsibilities and place the emphasis where it properly belongs. To do otherwise, might well make it appear that the internal auditor was trying to avoid all responsibility or carry virtually the whole company, to assume many responsibilities which logically lie elsewhere. With a proper definition of the broader responsibilities and a thorough understanding of the need for adequate teamwork and good judgment in the execution of that teamwork on the part of *all* segments of the company, it is possible to have adequate controls and at the same time efficient and economical operations.

Please keep this in mind as we continue, for I am sure that there will be many statements that I shall make to which many of you could easily take exception. Before taking exception, however, please ask yourselves if what I say might not be true and preferable under certain conditions in your own companies even though they might not

Internal Auditing as Applied in a Life Insurance Company

be under others. Keep in mind that basic need for teamwork.

Appraisal Activity

While one of the principal objectives of the internal auditor is to *appraise* through the means of periodic surveys, to observe and disclose faulty situations, the subsequent corrective action is the job of management. The internal auditor, functioning as a spotlight to reveal the needs for improvements, and the planning supervisor, functioning as a specialist in answering those needs, if your company is fortunate enough to have both and they operate independently of each other, admirably supplement one another.

The internal auditor should be familiar with existing procedures and forms, but he should not participate, except in a purely advisory capacity, in the development and installation of detailed systems and procedures. It is one of his normal functions, however, to report deviations from procedures and weaknesses in the system and to recommend desired improvements.

The internal auditor may assist, in an advisory capacity, in the development of new and revised procedures and forms. His responsibility, however, should be limited to the control aspects; which include an appraisal of the adequacy and propriety of the delegation of authority and responsibility. Auditors are human just like everyone else, and it does not require a very vivid imagination to picture the mental dilemmas in which they might well find themselves, were they to write operating procedures and design forms and subsequently appraise their efficacy. Under such circumstances, do you think they could appraise them objectively? Would they be as quick to institute changes if they found them lacking in some important respects?

Since internal auditing is fundamentally an appraisal activity, its scope is limited only by management's wishes and the competency of the auditing staff. Audits need not be confined to financial areas, but common sense and good judgment indicate that the auditor should guard against assuming responsibilities and expressing opinions in areas where his contribution would be of doubtful value. For example, it probably would be unwise for him to attempt to evaluate the propriety of the number of employees concerned with an operation being audited. He might make some general observations on the subject, if conditions which he has observed indicate obvious over- or understaffing. A thorough survey and final determination, however, should be accomplished by the planning group or the operating department. At the same time, there may be many opportunities for his making constructive suggestions for the benefit of his company and its policyholders, and it is his responsibility to properly utilize all such opportunities.

Fraud

Internal auditors cannot actually discover all frauds at their beginning, but they should always be alert to the possibilities. Since collusion of two or more employees might obscure fraud for a time, the objective of the internal auditor is to have the internal controls so effective that deviations from prescribed operating procedures or abnormalities in records will bring frauds to the attention of alert supervisors soon after they start. The internal auditor can accomplish considerable good by emphasizing with the company's supervisory personnel their responsibility for maintaining proper controls and *acting emphatically* on abnormal conditions that come to their attention.

Internal Auditing as Applied in a Life Insurance Company

In all cases of fraud, the internal auditor should control and guide the investigations and cooperate with the legal, financial and bonding company representatives. At the conclusion of each investigation, a full report should be rendered which would include a review of the failures of the controls and recommendations for any appropriate improvements in controls and procedures.

Research

Research in internal auditing never ends, for it must keep pace with ever changing conditions and improved knowledge. The internal audit program must constantly be reviewed, reappraised, and revised in the light of new experiences. The internal auditor must keep abreast of current developments in auditing and related fields and be constantly on the alert to make any desirable changes in the company's audit program, and to recommend appropriate changes in the company's policies or procedures for better and more effective controls.

Integration with Outside Auditors

The internal auditor and independent public accountants have a common responsibility in that both are interested in the company's accounting and financial statements and in effective controls. Careful planning is necessary to achieve the broadest practical audit coverage with a minimum of duplication. Internal audit reports and supporting data should always be available to the independent public accountants, and are an integral factor in their appraisal of the company's internal control structure.

Access to Company Records

The internal auditor should have freedom of access to all company records, and his *staff* position should allow

him independence of thought and action in his appraisal activities.

Place in Company

The title of the one to whom the auditor reports is not too important. Far more important, I think, is making him as independent as practical from duties of an operating nature and placing him under an officer who has sufficient authority in management channels to assure attention to and action on conditions brought to light and recommendations made in his reports. Moreover, it should be understood that, if he deems it advisable, he may at any time exercise his prerogative of reporting directly to any level of authority, the Executive Vice-President, the President, or the Board of Directors.

Protective Aspects

The internal auditor at all times is concerned with the "protective" aspects of auditing—the protection of assets, such as cash and securities, the adequacy of the controls and the avoidance of waste. The control over securities, the reconciliation of bank accounts, the detection of fraud, the pointing out of weaknesses that might prevent future errors or irregularities, the discovery of waste or the use of poor judgment, all have the same objective—more efficient and economical operations.

Training Ground

The internal audit department or division of a company could, with careful planning, be an excellent training ground where men, particularly those of proven and potential supervisory calibre, may be instilled with a philosophy of objectivity and an appreciation of the need for and value of sound controls and how to make them work. Some auditors put great stress on the importance of complete and up-to-date written audit procedures. It is true that

Internal Auditing as Applied in a Life Insurance Company

we must have certain guides, particularly for new men, and certain degrees of standardization. But we must guard against too great reliance on predetermined written instructions. We must train our staff to use such procedures as suggested guides only and to realize that they must constantly develop their imaginations and analytical abilities and always strive to color their judgment with an appreciation of the over-all needs of management. In an internal audit department, we have an excellent opportunity to acquire ourselves, and to train others to acquire, a broad knowledge of the company's operations, an understanding and appreciation of management's thinking and problems and an analytical ability.

Human Relations

We must never forget that internal auditing deals primarily with human beings rather than inanimate objects. A draftsman can perform his job at the drawing board or the chemist his in the laboratory. But the auditor, who initiates but very little himself, spends a great deal of his time appraising the work of others in the accounting and financial areas and in certain other operations, and he is concerned with improving the practices of those who perform these operations.

It is said that you can lead a horse to water but you cannot make him drink. To effectively improve the work of other people, you must deal directly with those people. By using good human relations techniques, by tactful communications, oral and written, by helpful suggestions rather than adamant demands, you can obtain willing cooperation.

If an internal auditor fails to make the other fellow feel important, he may

seriously impair his effectiveness as an internal auditor. Actually, the ones being audited are important, just as important as the internal auditor. If we had no operating personnel, we would have no need for auditors!

Benefits Obtainable

The maximum benefits obtainable from internal auditing will be achieved by:²

1. Careful selection and planned training of staff members.
2. Capable and imaginative leadership.
3. A well thought-out and organized audit program, agreeable to top management.
4. Constant study of the company's operations and programs.
5. Sound and friendly relations with all levels of management.
6. Salaries and opportunities for staff members that will attract the high quality of men required.

Conclusion

"The newer concept of internal auditing is that the responsibility of the internal auditor is not limited to the audit of the accounting records but extends to all operations. In order for the internal auditor to measure up to his increased responsibilities, it is necessary that he drop his former narrow preoccupation with the accounting records and assume an over-all concept of the organization. The auditor must develop ability to recognize how his recommendations will effect all departments of the organization. The management in adopting or rejecting the auditor's recommendations must consider the over-all effect upon the organization. The auditor will increase his value

² "Ten Fundamental Concepts of Internal Auditing," *op. cit.*, p. 40.

Internal Auditing as Applied in a Life Insurance Company

if he will use the same type of high level judgment in seeking solutions to problems encountered in the audit.³

"The objective of internal auditing . . . is to help management in obtaining effective, efficient and economical operations. The emphasis in internal audit reports should be placed upon the exceptions that require management attention . . ."⁴

In conclusion, I shall quote part of a speech given by Judge Harold R. Medina in which he discusses the difference between a liberal man and a conservative. I leave it to you to decide into which category an internal auditor should fit.

"A liberal man must be a thinking man, one who has learned to evaluate his experience and the world about him independently and freely, using the ideas of others only as the starting points of his own analysis and creativity. But this alone does not complete the picture. The liberal not only has his own concepts of right and wrong, desirable and undesirable, but is always prepared to accept criticism

and to try to understand opposing views. He constantly stands ready and is anxious to reappraise his own conclusions, ideas and concepts of truth in light of differing theories and new information available to him.

"The conservative differs from the liberal particularly in his reluctance to revise original estimates. He is not wholly without an inquiring mind and capacity for change, but he instinctively struggles against espousing new ideas and rejecting pre-existing notions of truth. In any appraisal in which he might engage, he seems to bestow a quality of good upon that which exists or which is current merely because it happens to be the prevalent practice or view right now."⁵

* * *

"We must be fearless and tolerant and receptive of new ideas and new interpretations. What we all wish for is more freedom. Not freedom to do as we please, to the detriment of ourselves and our neighbors, but the freedom that comes with wisdom and enlightenment."⁶

³ Landy, Charles B., "Internal Auditing as Related to the Audit Division, Commodity Stabilization Service, U. S. Department of Agriculture." *The Internal Auditor*, Sept., 1955, p. 25.

⁴ Landy, *ibid.*

⁵ Medina, Harold R., "The Road to Freedom is Difficult." An address at Trinity College, November 11, 1955, reprinted in *College and University Business*, January, 1956, p. 13.

⁶ Medina, *ibid.*, p. 15.



Audit of a Life Insurance Company by Independent Certified Public Accountants

By HENRY S. CHAPIN, C.P.A.

This paper discusses the nature of, and the values to be derived from, an audit of a life insurance company conducted by independent certified public accountants.

Gentlemen, as you well know, these are the closing minutes of a highly successful 34th annual conference of the Insurance Accounting and Statistical Association. At this point with the festivities about to come to an end, and many of you who are not New Yorkers about to leave for home, it would be appropriate to present something spectacular to you as a sort of grand finale.

Needless to say, the talk which Ed Mallon, our session chairman, has asked me to make about the scope of an audit of a life insurance company by independent certified public accountants and the value of the audit to the company under audit is not going to be spectacular. However, as a member of a firm of certified public accountants which has had the privilege of making or supervising such audits, I can safely say that the completion of an audit of a life insurance company in time to meet the annual convention statement deadline for filing with the State Insurance Department usually ends in a grand finale with fireworks. After com-

pleting, prior to the year-end, appropriate tests of the year's transactions and as much other preliminary work as may feasibly be done in advance, our staff accountants, complementing the officers and employees of the company and with little regard for the time of day or the day of the week, are faced, in the short time between the year-end and the convention statement filing date, with making an audit of the year-end assets and liabilities.

Highlights of the Year-End Audit Program for Assets and Liabilities

With one eye on the calendar, our accountants inspect bonds and stocks or confirm them with custodians unless they are already under audit control. The valuation of bonds and stocks is ascertained to be in conformity with the rulings of the National Association of Insurance Commissioners, as is the computation of the security valuation reserve.

Among other year-end audit procedures, investments in mortgages and real estate, as well as in that quasi-investment, policy loans, are found by test examination to be fairly stated and supported by appropriate evidence.

The year-end cash on hand is counted and that on deposit found to be in reconciliation with certificates from depositories, the reconciling items being audited, among other procedures, by reference to January bank statements and paid checks obtained directly

HENRY S. CHAPIN, C. P. A., is a member of our Society and the American Institute of Accountants. He is a member of the firm of Has-kins & Sells, C. P. A.s.

This paper was presented by Mr. Chapin on May 23, 1956, at a session of the Thirty-fourth Annual Conference of the Insurance Accountants and Statistical Association.

from the depositaries. Accrued investment income, premiums receivable from policy holders and other miscellaneous assets are reviewed, tested as to arithmetic accuracy and compared, as to reasonableness, with corresponding prior-period items.

Among other audit procedures applied to the liability side of the balance sheet, policy reserves are compared in some detail with prior periods as to reasonableness and evidence is obtained that the State Insurance Department, or an independent actuary, has taken adequate steps to determine the adequacy of the reserves.

Dividends and annuities left on deposit and premiums paid in advance by policy holders, which will have already been reviewed critically prior to the year-end because of the inherent difficulty of properly controlling these items, are subjected to further test-audit procedures as of the year-end.

The claim liability, both reported and unreported, is determined by test examination of actual claims and claim experience to be adequately stated.

Without going into detail, appropriate test-auditing procedures are applied to the remaining liabilities such as those for expenses, taxes, and dividends.

The Audit Certificate and Report

An essential and important result of this year-end audit is the accountants' certificate signed by the firm of certified public accountants and rendered to the company prior to the filing date of the annual convention statement. The certificate is a statement that on the basis of the audit it is the auditor's opinion that the financial statements of the company present fairly its financial position and results of operations.

As a rule this certificate is accompanied or promptly followed by a report which often contains commentary mat-

ter including, where necessary, recommendations as to the company's accounting procedures and other related matters.

At this point an appropriate question might well be, "What is the specific value to an insurance company of an accountants' certificate?"

From the moment of its signing and rendition, the accountants' certificate has practical value to the senior officers of the company as they sign the annual convention statement, since it constitutes substantial supporting evidence that the accounts as shown in the convention statement are fairly presented.

An accountants' certificate can also be described as an essential document for the Board of Directors as well as for the management of a life insurance company. It is prima facie evidence that they, as trustees of funds of potential widows, orphans, and aged annuitants, are taking at least the same precautions in providing independent annual auditing as is customary under generally accepted business practices for corporations having substantial public interest. These independent annual audits are required by the Securities and Exchange Commission under Federal law for industrial and public utility corporations having securities listed on any stock exchange in the United States.

A question now might be asked as to why under accepted business practice and under Federal law this is the case. It is with gratification, and some humility of the old fashioned variety, to be able to answer that this public acceptance appears to be the result of the continual maintenance by the accounting profession over a period of many years of a reputation for integrity and ability.

It is also gratifying to be able to point out that the public generally, including not only stockholders of business cor-

porations but also many policy holders of insurance companies, consider an accountants' certificate an essential part of an annual financial report.

At this point, with some concern that it may not be of too much interest, I would like to touch briefly on the technical aspects of the audit of a life insurance company. In the short time we have it isn't possible to be specific because of the differences in size of the companies and the surprising amount of variation between companies in procedures and organization.

Scope of an Audit by Independent Certified Public Accountants

But speaking very generally, it may be said that the scope of an audit of a life insurance company by independent certified public accountants, comprehends four phases.

1. Evaluation of Adequacy of Internal Control Procedures

The first phase is an evaluation, as to adequacy, of the control aspects of the life insurance company's organization and procedures. Collectively these controls are known generally as the internal control, a term originated by certified public accountants in an attempt to distinguish controls within a company from external controls such as those obtained through auditing.

Before proceeding with a further discussion of the four phases of an audit it might be appropriate to comment briefly on internal control as such, for it is an important factor in the determination of the extent of the auditing to be done by the certified public accountant.

The generally accepted basic concept of internal control, as I understand it, is that the involvement of two or more individuals in each transaction, or other accounting or related activity, minimizes

the likelihood of significant errors or irregularities. This concept is based upon the assumption not only that the check of an individual's activities by one or more other individuals will disclose actual errors or attempted irregularities but that it also will promote more care and tend to remove temptation.

As you know, in many life insurance companies, because of their magnitude, this concept of involvement of two or more individuals is broadened to comprehend two or more departmental units which, together with any individual officials or other employees who perform control functions, may well be described in evaluating internal control as control units.

In general, internal control is considered adequate if it appears that the interrelationship of the control units is sufficient to prevent or detect significant clerical errors and irregularities. However, in view of its basic concept, it should not be overlooked that, as a practical matter, internal control cannot economically be extensive enough to prevent, or detect promptly, irregularities which might be perpetrated by collusive action among a number of individuals in the control units involved.

The evaluation of internal control, which I have already mentioned as the first phase of audit, is made relatively less difficult where the company being audited has an organization chart and a procedural manual and possibly also charts, or the equivalent, indicating the flow of transactions. This is especially true if an internal auditing staff has developed its own conclusions as to the adequacy of the internal control. On the other hand, where a company has little formal evidence of its organizational responsibilities and procedures, the evaluation of internal control is a time-consuming and frustrating aspect

of an audit for it requires painstaking piecing together of information obtained by interviewing the company's personnel as to their duties as well as by careful observation of the actual flow of transactions through the various departmental or other control units.

2. Audit Tests to Determine Proper Functioning of Internal Control Procedures

The second phase of a life insurance company audit is the application to transactions of minimum audit tests sufficient to indicate that the prescribed internal control procedures, ascertained in the course of the first phase of the audit, are in fact being performed as prescribed.

Where a company has formal evidence of its control procedures, especially a procedural manual, these minimum tests which are the second phase of auditing, usually can be truly minimum for there is reason to presume that prescribed procedures are well known and are in fact being carried out. The reverse is true where procedures are not formally set forth and, accordingly, are being performed by rote.

3. Analytic Review of Operations

The third phase of an audit and one particularly adaptable to life insurance companies, because of the regular trends in the industry, is what is called in accountants' shop talk, an analytic review.

An analytic review means simply a study of the financial aspects of the business—comparison of items which should be comparable, investigation of fluctuations, consideration of possibilities of substantial errors or irregularities, and similar matters. A major part of the analytic review is applied to operating accounts. An analytic review of operating accounts consists generally speak-

ing of comparisons of the detailed accounts and of related significant ratios from month to month and with prior years. Fluctuations which appear abnormal are investigated and satisfactorily accounted for by discussions with informed officials. Where such investigations are not conclusive further auditing is required. The investigation of abnormal fluctuations and the determination of needed further auditing require exercise of judgment and discrimination.

It should be noted that where budgetary procedures are comprehensive the analytic review would include comparisons in detail of actual performance with the related budgets and investigation of material differences between the actual performance and the budget.

Application of Further Auditing Tests in Areas Indicating Need Therefor

Supplementing these first three phases (the evaluation of internal control, the minimum auditing tests, and the analytic review), the fourth phase of an audit is the application of further auditing tests in areas where the internal control appears inadequate and where the analytic review shows abnormal fluctuations which cannot be satisfactorily explained. These fourth phase auditing tests are also applied in areas where as a practical matter internal control is considered adequate but where there is a possibility of substantial loss as a result of the inherent ineffectiveness of internal control.

To make a pointed example, I doubt that any auditor would be willing to forego the inspection or control of securities held in the company's vaults, no matter how much internal control existed in the form of joint vault control by a number of company officials.

The completion of these four phases of auditing of a life insurance company is a prerequisite for the issuance of the

Audit of a Life Insurance Company by Independent Certified Public Accountants

accountants' certificate in which is expressed the auditors' opinion as to the financial position and operating results of the company under audit.

Values of the Independent Audit to Management

It would be an appropriate question at this point to ask, "Of what value are these four phases of auditing?"

I have mentioned earlier the value of the accountants' certificate as prima facie evidence that the customary precautions necessary under present generally accepted business practices have been taken by the directors and management to determine that the annual financial statements present fairly the company's financial position and its operating results. This determination is made promptly after each year-end. Being a matter of record annually it precedes by an extended period the opinion as to financial position and operating results of the State Insurance Department's examiners contained in their report following the Department's extended examination at the end of the customary (in most states) three-year examination period.

An important value of an audit is in the area of advice and consultation. The broad professional background and knowledge of a firm of certified public accountants, resulting from contact with varied industries and accounting problems, combined with specific knowledge of the accounts and operations of the company, obtained in the course of making the audit, provide the company's operating personnel with a source of advice and consultation in a number of directions.

For example, in the course of evaluation of the internal control, the auditor is able to express an informed opinion as to methods of improving the internal control and in this connection can advise

on the form and content of the related organization and flow charts, procedural manual, etc.

The auditor is also able to make observations and suggestions as to the efficiency, both as to personnel and records, of the accounting operations with emphasis on uses of accounting machines, particularly electronic equipment. A number of auditing firms, fully aware of the revolutionary aspects, of electronics in accounting, have established departments of specialists on the subject in order to be in a position to render consultation service and also to develop appropriate methods of auditing accounting records produced by electronics.

The professional knowledge of an auditing firm comprehends the subject of Federal income taxes. The advice and assistance of the auditor in preparation of tax returns is of increasing value because of the complexities of tax legislation applicable to life insurance companies and the growing amounts of taxes being paid by them.

An audit has value as a psychological stimulus to the accounting personnel of the company. This stimulus is inherent in their awareness that the accounts are subject to audit during each year by outside professional auditors. It is augmented by the presence during the course of the audit of the auditor's staff with their objective point of view, particularly at the year-end when important financial statement information has to be assembled accurately in a short time and under pressure. The awareness by the accounting personnel that the accounts are subject to outside audit during each year is also a constant deterrent to the perpetration of irregularities.

A further and obvious value of an audit is that in its course a substantial

Audit of a Life Insurance Company by Independent Certified Public Accountants

amount of actual auditing of the accounts is accomplished which otherwise to some extent might have to be done by internal auditors.

I have attempted to outline briefly the scope of an audit by certified public accountants and the value of the audit to the company being audited.

Statistics Regarding Auditing Services by Independent CPAs

Before concluding my remarks some statistics on the number of life insurance companies being audited at the present time would be pertinent.

Of the four largest companies measured in terms of admitted assets, the second and third largest, Prudential and Equitable, have had annual audits for many years. The largest company, Metropolitan, and the fourth largest, New York Life, are not audited, although both companies have retained the services of certified public accountants for consultation on such matters as internal control.

Of the remaining ten companies having admitted assets in excess of one billion dollars at December 31, 1955, four appear from available records to have annual audits. The exact proportion of companies with assets of less than a billion dollars is not readily determinable but there are many and the number is growing. Some who do not have annual audits use the services of accountants for studies of internal control procedures and for advice on accounting systems and mechanization. Others have followed the practice of retaining accountants for the purpose of verifying the portfolio of investments.

The logical question at this point would be, "Why do not all companies have annual audits by certified public

accountants in keeping with the accepted practice in business generally?"

The answer which is consistently given by the companies that do not have audits is that they do not feel justified in incurring the cost when by law and at company expense the accounts are eventually audited by the examiners of the State Insurance Department.

In taking this position with respect to auditing costs the directors and management of the company take the calculated risk which is inherent in the long intervals between the audits by the State Insurance Department that errors in the accounts or irregularities may not be disclosed promptly. They also forego the recurring contact with the auditors and the attendant opportunity for advice and consultation.

Certain companies have attempted to bridge the gap between the Insurance Department's triennial examinations by having annual audits by certified public accountants for the first and second years of each triennial period. This practice on occasion has led to a decision to have an annual audit every year, including the third year of the triennial period, the compelling reason being that the obtaining of the accountants' certificate and report promptly after the end of the year was advantageous even though at a later date the Insurance Department's report would become available.

I appreciate the privilege granted to me of talking to you about auditing which has been a subject of intense interest to me for most of my life. As officials of insurance companies I know that you have a comprehensive understanding of life insurance accounting, and I for one would like very much to have your reactions.



Accounting Aspects of Real Estate Syndicates

By LEO H. SEITELMAN, C.P.A.

The real estate syndicate is a popular and fast-growing method of financing real estate investment operations. In this paper the author discusses the accounting problems peculiar to this form of business organization.

Introduction

The real estate syndicate may be defined as a large group of people organized as a joint venture, partnership, or corporation for the purpose of acquiring, operating or leasing real estate for investment purposes. Syndicates were originally formed to acquire relatively large properties. However, today we find that syndicates are being formed for moderate-sized and smaller properties.

Form of Business Venture

Accountants are frequently asked for their opinion about the form of the business venture, namely whether the venture should be organized as a corporation or partnership. Every accountant is familiar with this type of problem. Very briefly the chief advantages of the corporation as compared with the partnership can be summarized as follows:

LEO H. SEITELMAN, C.P.A., is a member of our Society and of its Committee on Real Estate Accounting. He is also a member of the American Institute of Accountants. He is a partner in the firm of Leo H. Seitelman and Co.

This paper was presented by Mr. Seitelman at a technical meeting of the Society conducted under the auspices of the Committee on Real Estate Accounting on April 26, 1956, at the Engineering Societies Building.

Corporation

1. The stockholders enjoy limited liability.
2. Shares of stock can be more easily transferred and sold than partnership interests.
3. The corporation enjoys perpetual life without interruption because of the death, bankruptcy or other legal disability of any of its stockholders.

Partnership

1. The partnership is not subject to the "double tax" as in the case of a corporation.
2. If a partnership shows a loss for income tax purposes, each partner can deduct his respective share of said loss on his own individual income tax return.

In most cases, the partnership form is desirable because of the income tax advantages mentioned above. However, many investors will not join general partnerships, because general partners may be held liable for all partnership debts in excess of their capital contribution. To overcome this objection, limited partnerships are being formed, whereby the promoters are the general partners and the investors are the limited partners. Thus the limited partners enjoy all the income tax advantages outlined above and also enjoy limited liability. Therefore, it is easy to understand why the limited partnership form is being widely used by real estate syndicates at present.

Accounting Aspects of Real Estate Syndicates

Prospectus and Basic Documents

At the beginning of any accounting or auditing engagement, it is customary for the accountant to examine the basic legal documents underlying the particular venture. One of the most important documents in the case of real estate syndicates is the prospectus issued by the promoter.

Whether or not the promoter's prospectus is a legal document in the true sense of the word is a matter which can be decided only by an attorney. Nevertheless the prospectus contains very important data (e.g., physical description of the property, cost of the property, mortgages, business form and organization of the venture, estimated income, estimated expenses, estimated cash earnings to be distributed to participants, etc.). Therefore, the accountant should read and study the prospectus carefully.

In addition to the prospectus, the accountant should also examine all the other basic documents such as the purchase contract, closing statement, partnership agreement or corporate papers. If the venture is a partnership, the accountant should review the agreement carefully, since there have been partnerships which were held to be taxable as corporations. If the accountant has specific comments or suggestions concerning the partnership agreement, they should be discussed with the syndicate's attorney.

Last but not least, the accountant on beginning his engagement should make certain that all the regulations in regard to filing financial data with the Securities and Exchange Commission have been complied with. In brief, you may note the following:

- (1) In those cases where funds are solicited entirely from residents of New York State, attorneys have advised that it is not nec-

essary to file with the S.E.C., regardless of the total capital involved.

- (2) In those cases where funds are solicited from residents of New York State and residents of other states, attorneys have advised that a limited form registration statement is required if the total issue of the venture is less than \$300,000. If the total issue is more than \$300,000, then a long-form registration is required.

The popular conception that the Securities Act applies only to corporations is not true, because the Act also applies to partnerships which solicit capital investments from the public. If the accountant finds that the syndicate has not complied with the filing requirements of the Securities and Exchange Commission, he should immediately notify the management and the syndicate's attorney.

Promotion Expenses

The organization and promotion of real estate syndicates is a business. Therefore, it is basic that those individuals who organize and promote real estate syndicates work for a profit. The profit may be in one of several forms, as follows:

- (1) Cash.
- (2) Acquisition of an interest in the partnership or corporate stock without direct cash payment therefor in exchange for services rendered.
- (3) Combination of the above.

To illustrate the foregoing, let us consider a simple example. Let us assume that the promoter makes a contract to purchase property from Mr. X at a price of \$270,000, cash, over the mortgages. Furthermore, let us assume

that the promoter assigns the contract at a profit of \$30,000 to a real estate syndicate (partnership or corporation) which he is organizing, with a total capitalization of \$300,000. The promoter can then decide how to take his profit of \$30,000 as follows:

(1) If the promoter wants his \$30,000 profit in cash, then he will raise the total capital of \$300,000 from the other participants in the syndicate. Of the total \$300,000 capital, the sum of \$270,000 will be used to purchase the property and the promoter will receive \$30,000 in cash.

(2) On the other hand, the promoter may not want his \$30,000 profit in cash and he may be willing to accept an interest in the partnership or capital stock of the corporation valued at \$30,000. In this case, the promoter will raise \$270,000 cash from the other participants in the syndicate and this sum will be sufficient to purchase the property. The total capital will be \$300,000, consisting of the \$270,000 cash investment raised from the other participants and the \$30,000 interest in the capital taken by the promoter.

(3) Finally, the promoter may take his profit of \$30,000 by a combination of cash and an interest in the syndicate's capital.

Since we are discussing the subject of promoter's profits from the viewpoint of the syndicate, I will refer to this item hereafter as promotion expenses inasmuch as it constitutes an expense (albeit prepaid) to the syndicate. In many cases, the promotion expenses are actually stated in the prospectus. If the item is not clearly stated in the prospectus, it may be calculated from a review of the prospectus, purchase contract, or other official legal papers of the syndicate. In this regard it might be helpful to trace the receipt of amounts invested

by the partners or stockholders into the bank account and the disbursement of funds for the acquisition of the real estate.

It is important to note that there may be cases where it may be impossible to determine what the promotion expenses are. In other words, a review of the prospectus and all the legal documents will not reveal the amount of the promotion expenses, if any. Let us refer to the example cited above. Let us assume that the promoter organizes a syndicate to purchase the property directly from Mr. X at a price of \$300,000 over and above the mortgages. Furthermore, let us assume that Mr. X by a separate and private agreement agrees to pay the promoter a commission of \$30,000 for effectuating the sale. In this case, none of the syndicate's legal papers will show that Mr. X earned a commission of \$30,000. There are other methods which may be used to hide the promoter's profit but a discussion thereof is not within the scope of this paper.

Accounting for Promotion Expenses

Once the promotion expenses are known the question arises as to the accounting treatment of same. It is clear that this item is not part of the cost of the real estate. The promotion expenses represent the cost of organizing the syndicate and raising the capital for the venture. Therefore, the accountant should *not* charge the promotion expenses to a fixed asset account since this is improper.

In the past, some authorities have indicated that the organization expenses include the costs of promotion and activities involved in raising capital. However, it is interesting to note that Section 248 of the Internal Revenue Code of 1954 defines organizational expenditures as those expenses "incident to the

creation of the corporation" and is meant to include such items as incorporation fees, legal and accounting fees for organizing the corporation, etc. The promotion expenses which are under discussion do not come under the latter income tax definition. Therefore, it may be confusing to charge the promotion expenses to the organization expense account on the syndicate's books. In my opinion, the promotion expenses should be charged to an account which is clearly labeled and properly descriptive, e.g., underwriting expenses of stock issued, underwriting expenses of forming partnership, promotion expenses, etc.

Having set up the promotion expenses, the question arises as to the amortization thereof. In general, there are two schools of thought:

(1) Some accountants believe that the promotion or underwriting expenses have little intrinsic value after the venture is organized. Therefore, they favor amortizing the item by systematic charges to income over a 3-to-5-year period.

(2) However, many accountants feel that the promotion expenses in regard to the permanent proprietary capital should not be amortized, but that such expenses should be retained as an asset as long as the enterprise maintains its momentum as a going concern. These accountants favor the write-off of this asset to earned surplus upon complete liquidation, or a partial write-off upon partial liquidation of the enterprise.

The writer favors the latter procedure, namely, to retain the promotion expenses as an asset on the books until liquidation of the venture, provided that there is no impairment of value before then. I believe that most accountants handling real estate syndicates agree with this

view. At any rate, the financial statements should make full disclosure of the accounting principles used. These principles apply whether the venture is a partnership or corporation. This subject is discussed in Accounting Research Bulletin No. 43, in the chapter dealing with intangible assets.

In regard to the balance sheet, if the accountant decides to amortize the promotion expenses then they should be shown as a deferred charge. However, if the promotion expenses are to be retained as an asset until liquidation, then the item should be shown as an intangible asset.

Dividends and Surplus

In many real estate ventures, net cash earnings exceed net income. This may be explained briefly as follows:

(1) Net cash earnings is the difference between cash receipts and cash disbursements (including amortization of mortgages).

(2) Net income is the difference between income and expenses (including depreciation).

As you can note above, the chief point of difference lies in the fact that amortization of mortgages is deducted in computing net cash earnings, while depreciation is deducted in computing net income. As a general rule, if the amortization of mortgages is less than the depreciation expense, then the net cash earnings will exceed the net income.

It is a general policy of most syndicates to pay the maximum amount of the cash earnings to the partners or stockholders. In a partnership, this will not create a problem because there is no specific legal restriction on the amount of cash earnings which may be withdrawn by the partners except that part-

Accounting Aspects of Real Estate Syndicates

ners can be held liable for partnership debts. In some cases the partnership agreement may limit the amount of partners' withdrawals.

However, in a corporation a different problem may arise if dividends are paid in excess of net income. As a general principle of law, a corporation may pay dividends only out of surplus. In view of the fact that net cash earnings may exceed net income, it is possible to find real estate corporations paying dividends in excess of surplus.

If this situation is encountered, what should the accountant do? Obviously, the answer lies in "creating" surplus in a sufficient amount to cover dividend payments.

At this point, I would like to note that some accountants labor under the false impression that dividends may be paid only out of earned surplus. The fact is that in New York State, for example, dividends may be paid out of earned surplus, capital surplus, paid-in surplus, or any other type of surplus. The source of dividend payments is regulated by state law, and the accountant should be advised in this respect by the attorney for the venture. With this fact in mind, the following methods can be used to "create" surplus:

(1) *Reduce the value of the capital stock.* If capital stock has a par value, the par value may be reduced to a lower amount. If the stock has no par value, the total capital can be reduced to a lower amount. In either case, an entry on the books would be made reducing the capital stock account and crediting a designated surplus account.

(2) *Increase the value of the real estate to reflect appreciation.* If the real estate has appreciated in value, a proper appraisal should be obtained and the value of the assets may be increased in

accordance therewith. Of course, a properly entitled surplus account would be credited to reflect the appreciation in value.

(3) *Record depreciation in lesser amounts for corporate book purposes.* In most ventures, the policy is to take the maximum allowable amount of depreciation for income tax purposes. Usually the depreciation recorded on the corporation's books would be the same amount as shown on the income tax returns. However, there is no legal requirement that the depreciation deductions taken for income tax purposes are to be recorded in the same amounts for corporate book purposes. The latter fact indicates a possibility of creating surplus on the books, namely by recording depreciation in lesser amounts for book purposes.

The methods described above will increase the surplus on the corporate books. In any event, the approval of the stockholders and/or directors should be obtained. The accountant should not employ any of the above methods and write any entries on the corporation's books in connection therewith without such formal action, taken upon the advice of counsel.

Loans from Promoters

In some cases, the earnings of a real estate venture may not be as high as was estimated in the prospectus. However, many syndicate promoters insist on distributing profits or earnings in accordance with the amount promised in the prospectus even though such distributions exceed the actual cash earnings. Sometimes this policy is pursued because it is believed that the net cash earnings will improve in the near future. In other cases, the promoters pursue this policy so as to keep the good will of their clients.

Accounting Aspects of Real Estate Syndicates

Regardless of the reason, a point may be reached where the venture does not have sufficient cash to continue paying the established rate of corporate dividends or partnership distributions. Instead of reducing the dividends or distributions, many promoters will lend money to the venture and continue the established distribution policy.

In the case of a corporation, the accountant should make sure that the loans are recorded in the official minutes of the corporation. If not, they should be brought to the attention of the directors.

In the case of a partnership, the accountant should determine whether such loans are permitted by the partnership agreement. Furthermore, the partnership agreement should be checked to determine whether there is a prohibition against partners' withdrawals in excess of actual cash earnings. It may be necessary to bring this matter to the attention of the partnership's attorney for an opinion.

When the balance sheet is prepared, the liability should be clearly identified in the statement indicating the lender's name and whether the obligation is interest-bearing. Any interest expense in regard to such loans should also be clearly identified in the income statement.

Income Taxes

At the end of each calendar year, it is necessary to advise each syndicate participant what his status is in regard to income taxes. For example, in a partnership each partner must be advised what his share of the net income or loss is for income tax purposes. In the case of a corporation, each stockholder must be advised of the amount of taxable or non-taxable dividends paid to him. The accountant should prepare

these data and they should be mailed to the participants by the management.

However, sometimes the partners or stockholders are confused by the income tax data that they receive. The reason for this is that the normal reaction is to compare the income tax data with the accountant's income statement. If the taxable income is different from the net income shown in the accountant's report, the participants may find it difficult to reconcile the income tax data that they receive.

As you know, it is very likely that the taxable income will differ from the net income shown on the accountant's report. One example of this difference lies in the treatment of rent received in advance, which is treated as taxable income when received for income tax purposes but which is deferred for book purposes, etc. The differences are usually minor, but sometimes the differences may be substantial.

Therefore, the best procedure to avoid confusion on this account is for the accountant to prepare a brief covering letter to be mailed to the participants, reconciling the net income as per the accountant's income statement and the taxable income for income tax purposes.

Financial Statements

It is very important for the accountant to bear in mind that in the case of real estate syndicates his accounting reports and financial statements will be read by a comparatively large group of people. Therefore, these reports and statements should be prepared in sufficient detail so that the accountant will not be confronted by individual inquiries from partners or stockholders in regard to explaining various items appearing thereon. The accountant should follow the rule of full disclosure. Some

Accounting Aspects of Real Estate Syndicates

specific suggestions concerning the financial statements follow:

(1) In regard to the real estate and fixed assets, the first annual report should include a schedule showing the purchase price and all the other items which have been capitalized in these accounts (e.g., title insurance, legal fees, etc.). This schedule will support the asset values shown on the balance sheet. In subsequent accounting reports any increases or decreases in the real estate and other fixed asset accounts should be explained by a separate schedule.

(2) In regard to the mortgage liabilities, the first annual report should include a complete description of all the major terms thereof. For example, the report should reflect data for each mortgage showing original date, original amount, name of mortgagee, interest rate, terms of payment, maturity date, balance at maturity, etc. In subsequent accounting reports, it may not be necessary to repeat all such data.

(3) The income statement should show sufficient detail in regard to all the major items of income and expenses. For example, the rent income should be shown as rent income from stores, apartments, offices, etc. Similarly, the repairs and maintenance expenses should be analyzed into the major categories.

(4) In many cases, it is desirable to include a Statement of Application of Funds in the annual accounting report. Such a statement is very helpful in those cases where the total dividends paid to stockholders or the total cash withdrawn by partners during the year exceeds the net income shown by the income statement. In the latter case, the Statement of Application of Funds explains the source of the cash earnings.

In the case of a real estate venture, the Statement of Application of Funds

may be presented in a slightly different manner than that usually shown in text books. To illustrate the presentation of this statement let us consider the case of a relatively simple real estate venture as follows:

- (1) Start with the net income, as per the income statement.
- (2) Add depreciation deducted in the income statement, since this is a non-cash item.
- (3) The total may be labeled as "funds provided by profits".
- (4) Subtract amortization of mortgages, principal payments on other notes, and purchases of equipment.
- (5) The resulting figure may be labeled "cash earnings" or "cash return".
- (6) Deduct dividends paid to stockholders or withdrawals by partners.
- (7) The difference will be the increase or decrease in working capital.

Any real estate venture can use the foregoing form for the presentation of the Statement of Application of Funds with slight modification. Its advantage lies in the fact that the computation of the cash earnings is clearly set forth and, immediately following that, the total of the dividends paid or cash withdrawn is shown.

In general, a Statement of Application of Funds should cover a full fiscal year. Otherwise, the cash earnings will not be correctly reflected. As you know, operations during the winter months are not so profitable due to the high heating and repair expenses. Conversely, summer operations are more profitable. Therefore, the Statement of Application of Funds should preferably cover a full year of operations.

Accounting Aspects of Real Estate Syndicates

Before this discussion of financial statements is concluded, it is important to note that in some cases the management may ask the accountant to estimate the cash earnings for the coming year. I don't believe that it is proper for the accountant to include such an estimate in his annual accounting report. However, the proper procedure would be for the accountant to prepare this information for management purposes. Then the management may transmit it to the stockholders or partners on its own letterhead.

Conclusion

In conclusion, it is important to point out that while the accountant is usually engaged by the syndicate promoter, his first responsibility is to the partners or stockholders, to the public and third parties. It is evident that the partners or stockholders must of necessity rely upon the accountant for financial data. By accepting this responsibility and performing his professional accounting duties with skill and integrity, the accountant can do much to contribute to the future growth and development of real estate syndicates.



Income Tax Aspects of Real Estate Syndicates

By LEO SPANDORF, C.P.A.

This paper discusses some of the more important tax problems encountered in organizing, operating, and liquidating an interest in this type of business venture.

The decision to utilize the partnership or the corporation form of organization for the syndicate must be made only after giving consideration to the various elements which constitute the syndicate. They are:

- 1—The Participants
- 2—Type of Venture
- 3—Profit Pattern

The corporate type is readily identifiable. The partnership form has many variations, ranging from the general partnership to so called "trusts". Also included in this category are limited partnerships, tenants in common, and joint ventures.

LEO SPANDORF, C.P.A., is a partner in the firm of Kohleriter and Spandorf, CPAs, New York City. He has been a member of our Society since 1944, and a member of the American Institute of Accountants since 1946.

At present, Mr. Spandorf is serving as chairman of the Real Estate Accounting Committee and as a member of the Committee on New York State Taxation of our Society. He has lectured on tax subjects before various professional and business groups.

This paper was presented by Mr. Spandorf at a technical meeting of the Society conducted under the auspices of the Committee on Real Estate Accounting on April 26, 1956, at the Engineering Societies Building.

The Participants

The members of the syndicate fall into two categories—one group, representing the promoters, are at times identified as sponsors, managers, agents, trustees, general partners. The other group, representing the investors, are at times identified as shareholders, tenants in common, limited partners, and beneficiaries.

Types of Realty Venture

Generally, there are three purposes for which realty syndicates are formed:

- 1—Acquisition of income-producing realty evidenced by fee ownership or long-term leasehold.
- 2—Land development, such as construction of residential, commercial and industrial edifices.
- 3—Land speculation.

Profit Patterns

The profit patterns vary not only with the types of realty ventures, but the same type of realty ventures may offer different financial opportunities.

Realty under a long-term leasehold is acquired for an expected return on investment, where increment in realty value is secondary. On the other hand, income-producing realty may be acquired with the anticipation of increasing the return on investment by obtaining higher rentals, favorable long-term financing or installing efficient management. In this situation, we may en-

Income Tax Aspects of Real Estate Syndicates

counter an increased return in investment coupled with an increment in realty value.

The home developer anticipates substantial profits from sales within a relatively short space of time. The developer of income-producing realty can follow the path of the home developer or retain his newly developed holding for income.

The land speculator trusts that his judgment will be rewarded in due time with large profits from the sale of his land.

Non-Tax Consideration

Besides the tax motives, there are other considerations which may influence the choice of organization, namely:

- 1—Limitation of personal liability
- 2—Centralization of management
- 3—Continuity of ownership
- 4—Transferability of interests
- 5—Evidence of ownership

The tax advantages of operating in a partnership form in certain instances may far outweigh the above non-tax considerations. The use of a limited partnership may afford to some of the members of the syndicate some, if not all, of the corporate attributes.

The desirability of these non-tax features, which are inherent in the corporate organization, and the potential tax advantages of the partnership form, have led to the drafting of intricate and often ingenious syndicate agreements.

Tax Problems of the Partnership

(a) Associations Taxable as a Corporation

This brings us to the major tax problem of the partnership syndicate, an association taxable as a corporation.

There are a sufficient number of court decisions¹ which offer tax and legal advisors ample guidance to avoid the pitfall of being classified as an association taxable as a corporation. In judging an association, the courts will determine whether the syndicate resembles a corporation with respect to

- 1—Continuity of enterprise
- 2—Transferability of interests
- 3—Centralized management
- 4—Continuity of title

The courts have stated that mere resemblance is sufficient, not close identity.² If there is reasonable doubt, the syndicate should seek an early ruling from the Treasury Department. Where a syndicate is held to be taxable as a corporation by the court, the syndicate members face the burden of double taxation, once on the corporate level and again on distributions to the members to the extent of earnings and profits arising from operations and sale of assets.

(b) Examination of Individual Returns

When an Internal Revenue Agent is required, upon audit, to make a change in the net taxable income of the partnership, he adjusts the respective shares of taxable income of the partners involved. In a syndicate, this may be a considerable administrative problem

¹ The leading case is *Morrissey v. Commissioner*, 296 U. S. 344 (1936). This case has been cited repeatedly throughout the years.

² In *Morrissey (supra)*, the Supreme Court stated, "The inclusion of associations with corporations implies resemblance; but it is resemblance not identity."

The Ninth Circuit, in *Bloomfield Ranch et al. v. Commissioner*, 167 Fed. (2d) 586, cert. den. 335 U. S. 821, (1948) discusses in detail the points of resemblance enumerated above.

Income Tax Aspects of Real Estate Syndicates

and discourage the agent from making minor changes to net income. However, where the agent proceeds with his adjustment to taxable income, each of the tax returns of the syndicate members must be changed accordingly. This affords the Internal Revenue Service another opportunity to scrutinize the other items in the individual tax returns for possible adjustments.

(c) Fiscal Years

Under the 1954 Internal Revenue Code³, a partnership no longer has the right to select a fiscal year to suit its purposes unless prior consent is obtained from the Commissioner.

Tax Problems of the Corporation

(a) Thin Corporations

The most serious problem of an income-producing realty syndicate revolves about the difficulty in the withdrawal of earnings. This has led to the thin-corporation device.

As in almost all instances of tax planning, a reasonable approach to the thin-corporation situation may offer the taxpayer some assurances of approval for his actions.

Recently, the Tax Court held that a 56 to 1 debt to capital ratio was not recognizable as debt for income tax purposes.⁴ The fact that the debt to capital ratio varied with each stockholder was immaterial. All interest payments on the obligations and repayments of said obligations were considered to be dividends. On the other hand, a 3½ to 1 debt to capital relationship has been approved by the same court.⁵ There is no magic formula: Each passing month brings us new court decisions on this matter.

(b) Collapsible Corporations

The enactment of the collapsible corporation provisions of the current and prior Internal Revenue Code has probably caused the creation of more partnerships in lieu of corporations for the development of real estate than any other section of the Code.

This section was designed to prevent the conversion of ordinary income into capital gain by use of the corporate device. The Congressional Committee hearings specifically referred to the movie and construction industries. The Revenue Act of 1951 increased the scope of the collapsible corporation by including the purchase of property.

The question whether real property is acquired or developed for investment or sale in the ordinary course of business will depend on the well-worn comment, the facts in the situation.

Where a possibility exists that the gain from the sale of realty to be developed by the syndicate operating as a partnership may be deemed to be ordinary income because of past activities of the syndicate or the principal members of the syndicate, the corporation can assure capital-gain treatment if the syndicate is willing to wait three years.

The ordinary-gain provisions of the collapsible corporation will not apply to sales of corporate stock by the stockholders:⁶

- (a) three years after the completion of the construction or development of the property;
- (b) who own less than 5% in value of the stock of the corporation; or
- (c) where less than 70% of the gain is realized from the appreciation

³ Section 706(b).

⁴ *The Colony, Inc.*, 26 TC, No. 3, (1956).

⁵ *Ruspyn Corporation*, 18 TC 769 (1952).

⁶ Section 341(d).

Income Tax Aspects of Real Estate Syndicates

in value of the realty assets so constructed or developed.

A recent Tax Court decision,⁷ the first one on Section 117(m) of the 1939 Code, mentions that, in applying the 70% rule, gain attributable to non-construction activities, namely, rezoning or full occupancy, is excluded.

Compensation of Officers

The amount of compensation for services rendered by the promoters of the syndicate is usually negotiated beforehand and made part of the syndicate agreement. Under such circumstances, reasonableness of compensation should present no serious tax problem.

Where the compensation received is subject to high personal rates, the promoters may find it to their advantage to form wholly-owned corporations. Fees for management of realty properties can be paid to a corporation on a flat-fee or percentage-of-rental basis. Where property is being developed, the promoters may form a construction corporation which will erect the building on a cost-plus or fixed-fee basis. Care should be exercised to avoid the problem of a personal holding company.⁸

Organizing the Syndicate

Let us take a typical factual situation relating to income-producing real estate.

The promoter has entered into a contract to purchase an apartment house for \$290,000, subject to a first mortgage of \$200,000. He organizes a syndicate of investors to acquire 90% of the ownership for \$90,000. The cost to the promoter for advertising, soliciting, and organizing the syndicate is \$2,000.

Assuming that a corporation is used, the promoter assigns his contract to purchase the realty to the corporation for 10% of the common stock and securities in a tax-free exchange under Section 351. His basis for the stock is \$2,000, representing his cost to organize the syndicate. Since this expense does not come within the definition of corporate organizational expenses, the 60-month amortization deduction is not available to the corporation.⁹

The corporation proceeds to sell the remaining 90% of the stock and securities for \$90,000, which is used to acquire the property. The basis of the land and building is \$290,000 to the corporation.

As a result of the above transactions, the promoter defers the taxation of his apparent economic gain until he sells or exchanges his common stock.

The secondary problem is the determination of the ratio of stock and securities by the members of the syndicate. The definition of securities, in the form of notes, was recently reviewed by the Fifth Circuit in *Camp Wolters Enterprises, Inc. v. Commissioner*.¹⁰ I have commented previously on the "thin corporation" situation.

Upon the formation of a partnership, the promoter contributes the realty purchase contract for his respective interest in the partnership. The other members of the syndicate acquire their interest for the \$90,000 cash invested by them. As in the example illustrated above for the corporation, the basis of the realty assets to the partnership is \$290,000. The basis of the promoter's interest in the partnership is \$2,000 plus his respective 10% share of the mortgage liabilities which is \$20,000, or a total basis of \$22,000. Assuming

⁷ *Weaver*, 25 TC, No. 121 (1956).

⁸ Section 543(a)(5).

⁹ Regulations 1.248-1(b).

¹⁰ (CA-5) 230 Fed.(2d) 555 (1956); cert. applied for by taxpayer, May 28, 1956.

Income Tax Aspects of Real Estate Syndicates

that the investors are general partners and not limited as to losses, their basis is \$90,000 for the cash they invested plus their respective share of the mortgage or \$180,000, making a total partners' basis to them of \$270,000. The new partnership provisions of Section 752 of the Internal Revenue Code provide that the partners' bases shall be increased to the extent of the liabilities, assumed or acquired.

In both the corporate and partnership situations, where the promoter receives \$10,000 in cash for his 10% interest at the time of the organization of the syndicate, he has ordinary income in the amount of \$8,000 (\$10,000 less \$2,000 promoters' expenses).

Operating Profits and Losses

(a) Income-Producing Realty

The most important consideration is the relationship between the depreciation deduction and the mortgage amortization expenditure.

Where amortization exceeds depreciation, high-tax-bracket investors may be inclined to employ the corporate organization. The tax burden is reduced by having a part or all of the profits taxed at the 30% corporate level. As a result, more funds are available for reduction of liabilities or acquisition of additional realty.

The second tax at capital-gain rates is postponed until the liquidation of the corporation or sale of the stock or realty. In certain limited situations the second tax is completely avoided.¹¹

The high-tax bracket investor may reduce the tax impact in a profitable partnership syndicate by gift of his interest

to family or by creating irrevocable or "Clifford type" trusts.¹²

The partnership form is generally favored by syndicates holding income-producing real estate. The two factors are the avoidance of the second tax problem of the corporation, and the ease of withdrawal of funds.

Where the allowable depreciation deduction is in excess of mortgage amortization payments, the investor faces the happy prospect of obtaining funds unfettered by taxation. The partnership form is ideal for this situation. According to Section 705, the excess of distributions over taxable income will reduce each partner's basis. But Section 752 permits the liabilities of the partnership to be added to the partner's basis as illustrated above. Since income-producing real estate is invariably encumbered by mortgages, the basis of the partner's interest will rarely approach zero.

Section 752 or the Regulations relating to such section fail to indicate whether this favorable tax position is available to limited partners, whose losses are limited to the extent of their investment.

A negative basis of a partner's interest resulting from an excess of cash withdrawals over taxable income will result in taxable capital gain under Section 731(a) to the extent of such excess. A provision in the partnership agreement to charge such partners with a loan due to the partnership for such excess will prevent the imposition of a capital gain.¹³ However, it is questionable whether a loan provision is feasible in large syndicates.

Taxable losses creating a negative basis will be limited to the extent of

¹¹ Section 1014.

¹² Section 673(a).

¹³ Rabkin & Johnson, *Federal Taxation*, Para. 16.08(3) and 16.08(5).

Income Tax Aspects of Real Estate Syndicates

basis.¹⁴ However, subsequent taxable income will be reduced by the losses not previously allowed.

A syndicate acquiring low-yielding real estate with the anticipation of increasing the yield by alterations or renovations, will find the partnership form preferable for tax purposes during the initial period. Should the taxable income increase to a point where the syndicate members find themselves in high tax brackets, the partnership may be incorporated tax-free under Section 351, provided that the liabilities transferred do not exceed the basis of the assets.¹⁵ A syndicate of less than 50 members may elect to be taxed as a corporation within 60 days after the close of the year.¹⁶

(b) Land Development

During the construction of income-producing property, deductions for carrying charges¹⁷ are available to the members of the partnership syndicate. Immediately prior to the completion of construction, the syndicate must decide whether to continue under partnership form or to incorporate.

Where the renting of space indicates a favorable cash return, which can be offset to a large degree by the high depreciation rates available to new assets, the partnership form should be continued. A projection should be made indicating the relationship of amortiza-

tion payments on mortgages to allowable depreciation. However, if the taxable income is substantially the same as cash income, and such taxable income is subject to high individual tax rates, the corporate form is desirable. Since the change to a corporation is made prior to completion of construction, the higher depreciation rates are available to the corporation.¹⁸

The successful development of realty for sale, such as residential home development, will result in large ordinary income within a relatively short period. Under such circumstances, the creation of multiple corporations, within the realm of reason, will provide a better tax haven for income dollars than the partnership organization.¹⁹ A variation, by having the partnership perform one of the functions of the home development, while the remaining functions are performed by several corporations, may result in further tax savings.²⁰ The foregoing tax advantages will hold true even if all of the corporations are required to be completely liquidated at the termination of the venture.

(c) Land Speculation

The land speculators are confronted with the problem of being dealers in real estate as a result of their activities in subdividing land. Where the syndicate is willing to hold the land in a corporation for more than three years after

¹⁴ Section 704(d).

¹⁵ Sections 351 and 357(c).

¹⁶ Section 1361.

¹⁷ Interest, under Section 163; and taxes, under Section 164.

¹⁸ Section 167(c) and Rev. Rul. 56-256, I.R.B. 1956-25, 9. Section 381(c)(6) limits the carryover of the method of depreciation to transactions coming under certain provisions of Sections 332 and 361. The incorporation of a partnership is governed by Section 351. But a partnership electing to be taxed as a corporation under Section 1361, can continue its method of depreciation, thus avoiding the problem of Section 351. It is not within the province of this paper to discuss in its entirety the relative merits of employing Sections 351 or 1361.

¹⁹ The advantages of multiple corporations can be nullified by the failure to avoid the application of Sections 1551 and 269.

²⁰ The taxpayers were successful when challenged in *Seminole Flavor Co.*, 4 TC 1215 (1945), Acq. 1945 CB 6; *Buffalo Meter Co.*, 10 TC 83 (1948), Acq., 1948-1 CB-1; *Grenada Industries*, 17 TC 231 (1951); *Comm. v. Chelsea Products, Inc.*, (CA-3) 197 Fed(2d) 620 (1952).

On the other hand, the taxpayers were unsuccessful in *Advance Machinery Exchange, Inc. v. Comm.*, (CA-2) 196 Fed(2d) 1006; cert. den., Oct. 13, 1952, *Alpha Tank & Sheet Metal v. U. S.* (Ct. Cls.), 116 Fed. Supp. 721 (1953).

Income Tax Aspects of Real Estate Syndicates

acquisition and subdivision, capital gain²¹ will be realized from the sale of stock to purchasers who will then liquidate the corporation under Section 334 to obtain the assets. If the activities of the land speculation syndicate are continuous, the purchase of separate parcels by individual corporations may be desirable. The double tax, once on the corporate level at 30%, and the subsequent capital-gains tax on liquidation, may be less than the single tax on ordinary income imposed on individuals.

Sale of Interests in Syndicates

Gain resulting from the sale of corporate stock, representing the investor's share of ownership in a syndicate, is normally a capital gain.²² However, consideration must be given to Section 341 to determine whether the gain falls within the provisions of the collapsible corporation rules.

Gain from transfer of partnership interests by sale must be examined in the light of the collapsible partnership provisions of Section 751. If the assets of the partnership are held to be for sale to customers in the ordinary course of business, the gain may be taxed as ordinary income.

The 1954 Code introduces a new con-

cept dealing with the transfer of partnership interests. The basis of the partnership assets can be different to different partners. For example: Because of an increase in value of real estate from its cost of \$100,000 to \$150,000, a 10% partnership interest having a basis of \$10,000 is now sold for \$15,000. The partnership, not the partners, can elect under Section 754 to increase the partnership's basis on the real estate by the \$5,000 gain on the sale of the partners' interests. The increase in basis is available only to the new partner. Section 755 defines the method of allocating the increase in basis among the assets of the partnership. Thus, the new partner will enjoy a greater depreciation deduction than the original partners.

Once the election is made, it applies to all future transactions.²³ The acquiring partner has no choice. Where partnership interests are sold at a loss, the basis of the assets is reduced accordingly. Permission must be obtained from the Commissioner of Internal Revenue to revoke the election.²⁴ While this election will serve to advantage in a favorable real estate market, it does present administrative difficulties where interests are frequently transferred by sale or death.

²¹ Section 341(d)(3).

²² Section 1221.

²³ Regulations 1.754-1(a).

²⁴ Regulations 1.754-1(c).



J. Lee Nicholson

By THE COMMITTEE ON HISTORY

The man whom we know as a pioneer in cost accounting and founder of the National Association of Cost Accountants was born Jerome Lee Nicholson in Trenton, New Jersey, on September 24, 1863. Though his formal education was limited to that obtained in grammar school, he must later have studied extensively and to good advantage, for he became in time a lecturer and a widely published author in his special field.

When he was still a boy, his family moved from Trenton to Virginia and from there to Pittsburgh, where he worked as an office boy for Keystone Bridge Company. From office boy he advanced to a job as accountant for the Pennsylvania Railroad, and in 1885, when he was twenty-two years old, he embarked upon a selling career. For four years he traveled as a salesman for S. Katz & Company of New York, making his home in New York City. Here he used his diverse talents to supplement his income. Because he was an exceptionally fine penman his friends employed him to write business cards. He also studied bookkeeping and accounting in his spare time and profited from his new knowledge by writing up books and accounts in his evening hours.

In 1889, he decided to set up a public accounting practice of his own and opened an office on Broadway above Grand Street, near the old Prescott Hotel.

He early availed himself of the newly-provided opportunity to acquire the CPA

certificate, which New York State was the first to offer, and in 1901 became the holder of CPA certificate No. 190W. No doubt he had followed the early beginnings of the New York State Society of CPA's with interest, for he became a member in 1902, at which time the Society had been in existence for about five years. As early as 1906 he held membership in the American Association of Public Accountants, the predecessor of the American Institute of Accountants.

Perhaps it was his work in the drafting department of the steel mill at Pittsburgh which led to his interest in costs. At any rate, in 1909 he published a major work on the subject, a book entitled *Factory Organization and Costs*, brought out by Kohle Technical Publishing Company. As an authority in the increasingly important field of costs, he was engaged in 1911 to lecture on cost accounting at the School of Commerce, Accounts, and Finance of New York University. He also served as instructor and lecturer on that subject at Columbia University from 1912 to 1917.

During this period his interest in and knowledge of the subject increased steadily, and in 1917 he published, through Ronald Press, his second book, *Cost Accounting—Theory and Practice*, to be followed in 1919 by the Nicholson-Rohrbach volume, *Cost Accounting*, also published by Ronald Press.

In the meantime, he had been contributing to the work of the New York State Society. After serving in 1913-1914 as a director and member of the complaint committee, he became a first vice-president of the Society and held that post from 1914 to 1917. In 1917 when World War I was in progress, he

This is the twentieth in a series of articles on the History of Accounting in the State of New York. It was prepared by the Society's Committee on History.

J. Lee Nicholson

was called by the Government to be Chief of the Division of Cost Accounting (war contracts) in the Bureau of Foreign and Domestic Commerce, became a consulting cost specialist for the Federal Trade Commission, and on November 15, 1917, became a Major, Ordnance Department, Officers Reserve Corps, with the title of Supervising Accountant.

The war over, his strong interest and wide experience in costs led him to call a small group of men together for an organization meeting in Buffalo on October 13 and 14, 1919. Thirty-seven people were present. Those who attended from New York were, besides Mr. Nicholson, Walter S. Gee, Harold Dudley Greeley, and Alfred J. Stern. At this meeting the National Association of Cost Accountants was founded and Major Nicholson was chosen its first president. The stated object of the association was to "advance the science of cost accounting through such avenues as research, discussion, and acquisition and diffusion of cost accounting knowledge."

In memory of the founders of NACA, and especially of Major Nicholson, whose career was centered around the subject of costs, the Spot Club presented a bronze plaque to NACA in November, 1949.

He died in San Francisco on Sunday morning, November 2, 1924, not long after the publication by Ronald Press, in 1923, of his last book, *Profitable Management*. He was sixty-one years old at the time of his death.

The Society's files contain this resolution, which is a fitting testimony to a colorful career in accounting:

"On November second (1924) through the death of Major J. Lee Nicholson, one more has passed from our active membership, where for a long time his name was inscribed. Through all these years we who knew him had learned increasingly to admire him for his character and accomplishments, not the least of which was the service he so cheerfully rendered his country.

"We learned to believe in him and were glad for the broad recognition which was given to his abilities—we followed with our respect and support his efforts and lead in the organization of the National Association of Cost Accountants, which is a monument to his special achievements, and we record our own sense of our own loss through his death.

"To his partners and to his family we express our deep and abiding sympathy."

"For the committee:

(Signed) John F. D. Rohrbach
Harold Dudley Greeley
Edward L. Suffern"

The years spent by Jerome Lee Nicholson in studying cost problems and in arousing an interest in the development of cost analysis provided a major contribution to accounting history. His published works, together with the huge store of literature built up through the association which he founded, are a reservoir widely drawn upon in the management, operation, and control of business enterprise.



New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Claims for Revision under Art. 9 or Art. 9A . . . Interest on Refunds . . . Credits for Overpayments . . . Claims for Revision under Art. 16 and 16A . . . Credit against Tax under Section 373-1.

Claims for Revision under Art. 9 or Art. 9A

A protest against an assessment made by the Commission must be made by filing an application for revision on form 7CT. Such an application must be filed within two years from the date of the assessment notice. It should be noted that this differs from the federal rule which is fixed by filing dates or payment dates. In the case of a reaudit or restatement of an account the claim for revision must be filed within one year from the date of the restatement of the account.

Form 7 CT is obtainable only from the Albany office of the Corporation Tax Bureau upon written request. The purpose of this procedure is to enable the Tax Commission to settle any disputes without filing a formal claim for revision. If more than one year is involved a separate form must be filed for each year. The form itself calls for a

detailed statement of the basis for the claim and also the actual amounts claimed.

Interest on Refunds

An overpayment of franchise tax may be refunded or credited to the taxpayer, but without interest. This is an inequitable procedure because interest is payable on additional assessments. Under the federal law interest at the rate of 6% is payable on refunds.

Credit for Overpayments

On an overpayment of tax the Tax Commission may credit the corporation with the amount of overpayment. The corporation may assign the credit to any taxpayer subject to tax under the same article. A credit received by an Article 9A company may thus be assigned to any other Article 9A company, but such a credit may not be assigned to a corporation taxable under Art. 9.

Claims for Revision under Art. 16 and Art. 16A

Under the income tax law a claim for revision may be made within two years from the date a return was due, or the date of the payment of the tax, whichever is earlier; or within one year from the time a tax was assessed. The application for revision is made on Form IT-113. If the application is denied, after an informal hearing on the claim, the taxpayer may then make a formal demand for a hearing on Form IT-114. This demand must be made within 90 days after notice of a denial on the application for revision.

The formal claim is important if the taxpayer intends to have a judicial re-

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928, and a member of the American Institute of Accountants since 1922. He is a member of the New York Bar and Professor of Law at St. John's University.

Mr. Harrow is a past Vice-President of the Society. He is a past Chairman of the Committee on Publications and of the Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

(Continued on page 562)

Accounting at the S. E. C.

Conducted by LOUIS H. RAPPAPORT, C.P.A.

Proposed Revision of Rule Relating to Pro Forma Financial Statements

For many years the SEC has had in effect a rule (designated Rule 170) relating to the use of financial statements which give effect to the sale of securities and application of the proceeds. The rule is applicable to financial statements included in registration statements and prospectuses filed under the Securities Act of 1933. A somewhat similar rule (designated Rule X-15C1-9) exists with respect to financial statements filed under the Securities Exchange Act of 1934.

The present rule under the 1933 Act provides as follows:

Rule 170. Prohibition of Use of Certain Financial Statements.

Financial statements which purport to give effect to the receipt and application of any part of the proceeds from the sale of securities for cash shall not be used unless the sale of such securities is underwritten and the underwriters are to be irrevocably bound, on or before the date of the public offering, to take the issue. The caption of any such financial statement shall clearly set forth the names of the underwriters and the assumptions upon which such statement is based. The caption shall be in type at least as large as that used generally in the body of the statement.

The rule was designed principally to prevent the use of pro forma balance sheets giving effect to financing unless there is reasonable assurance that the securities will be sold. Under this rule, if the underwriters will not be irrevocably bound on or before the date of

the public offering to take the proposed issue of securities, pro forma statements giving effect to the financing may not be used. If a public accountant is called on to assist in the preparation of a pro forma balance sheet of this type, he should ascertain the nature of the underwriting commitment, that is, whether the underwriters are to be irrevocably bound on or before the public offering date to take the securities. In the investment banking business an agreement is considered to be "firm" despite the existence of a clause by which the underwriter may exercise an "out" if economic, political, market or other factors at the time of the proposed offering are such as to make the offering, in the opinion solely of the underwriter, unwise. Under Rule 170 the agreement must be more than "firm"; at the date of the offering the underwriters must be "irrevocably" bound.

The Commission now has under consideration a proposed revision in Rule 170. The proposed amendment would make it clear that the rule is intended to permit the use of financial statements not only in cases where there is a firm commitment to take the issue, but also in cases where there is no such commitment, provided the underwriters agree to take all the securities, if any are taken, and to refund to public investors all subscription payments made in the event that the underwriters elect not to take the issue. The proposed new rule, if adopted, would read as follows:

Financial statements which purport to give effect to the receipt and application of any part of the proceeds from the sale of securities for cash shall not be used unless the sale of such securities is underwritten

LOUIS H. RAPPAPORT, C.P.A., a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.As., is the author of *SEC Accounting Practice and Procedure*.

and the underwriting arrangements are such that the underwriters are or will be committed to take and pay for all of the securities, if any are taken prior to or within a reasonable time after the commencement of the public offering and if the securities are not so taken the subscribers will be refunded the full amount of all subscription payments made for the securities. The caption of any such financial statement shall clearly set forth the assumptions upon which such statement is based. The caption shall be in type at least as large as that used generally in the body of the statement.

The proposed revision would permit the use of pro forma balance sheets giving effect to financing where the underwriters' commitment is of the "best efforts" variety provided that if any of the securities are taken, all of them

must be taken. The proposal also contemplates that since the subscription payments of the public investors would be refunded in the event that the underwriters elect not to take the issue, presumably no one would be hurt if pro forma balance sheets are used in these circumstances.

We understand that the proposed revision merely formalizes what has been the practice for several years of the SEC's Corporation Finance Division in its administration of the 1933 Act. In other words, by this revision the SEC intends to bring its rule into line with its practice. If any reader wishes to comment on the proposal, he should communicate promptly with the SEC.



New York State Tax Forum

(Continued from page 560)

view of the issues. The facts and evidence submitted at the formal hearing become the basis of an appeal to the courts. If a formal demand on Form IT-114 is not made within 90 days, there is no basis for any appeal to the courts. This requirement is now strictly construed by the Tax Commission. To avoid any question of whether the formal claim has been filed, a taxpayer should mail the claim in time for it to be received within the 90-day period. It is also advisable to send such a claim by registered mail and request a return receipt.

Credit against Tax under Section 373-1

If a deduction is disallowed in a given year on the ground that it should have been taken as a deduction in a prior year, the Tax Commission may recompute the tax for the prior year. The resulting overpayment is then allowed as a credit against the additional assessment for the later year. Two conditions for the credit must be met. The allowable year for the deduction may not be more than five years prior to the year of disallowance, and the credit may not exceed the additional assessment in the later year.



Off

A for
aspect

Condu

Offic

Care

Socia

Office
Meet

For
City m
be info
the in
each m
office m
ees) fo
of idea
The su
entire
includi
relation
ports a
operati

The
Tuesda
Roosev
prior
drop in
group

Ther
in the
and eve
sessions
auto tra

MA
is a
mittee
ant's
Societ
ants.
Colleg
course
Block
Anchi

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Office Managers' Monthly Lunch Meetings . . . Employees' Air Travel . . .
Care of Work Papers on the Job . . . Bulletins to Clients Re Higher
Social Security Tax Rates.

Office Managers' Monthly Lunch Meetings

For the benefit of new New York City members, and others who may not be informed, attention is directed to the informal luncheon meetings held each month by a group of accounting office managers (partners and employees) for the discussion and exchange of ideas on administration problems. The subjects discussed embrace the entire gamut of the daily problems, including such subjects as personnel relations, pay scales, control over reports and tax returns, office equipment, operating efficiency, etc.

The meetings are held on the last Tuesday of each month at the Hotel Roosevelt, starting at 12:15 P. M. No prior registration is necessary; just drop in and join a pleasant, interested group of fellow practitioners.

There is a place for such meetings in the large cities throughout the state and even in sparser areas where dinner sessions would be within reasonable auto travel distance.

MAX BLOCK, C.P.A. (N. Y., Pa.) is a former chairman of the Committee on Administration of Accountant's Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.

Employees' Air Travel

Air travel by accountants in the course of their employment is common. What insurance protection is provided for the employee and employer against the hazards of a crash?

From the viewpoint of the employee, he should be covered by a large "trip insurance" policy, as a minimum. The charge is so small that \$50,000 to \$100,000 coverage may not be unreasonable, and the premium should be paid by the employer. Men should be advised that they are expected to obtain such insurance at the airport, unless the firm handles the coverage itself.

From the employer's viewpoint, an air accident may or may not be covered by compensation or liability policies, dependent on the provisions of the policies. Wherever practical, the individual trip insurance might be tied in with the compensation and liability insurance to give the employee a substantial amount of coverage and, at the same time, protect the firm against large claims. This subject is one for discussion with your insurance broker.

Care of Work Papers on the Job

Like the indifference developed by the chauffeur who daily drives a truck loaded with dynamite, so can an accountant react to the preservation of the privacy of work papers on the job. This recent incident brought the point forcefully to one accounting practitioner. An indignant client called him on the telephone to complain about a

Office and Staff Management

staff man's disregard for the privacy of confidential papers. Upon leaving for lunch, all of the accountant's papers were left widespread, and in convenient form for snoopers, on his desk. Right on top was a filled out bank statement form. A company salesman, requiring the use of a desk for a little while, sat down at the accountant's desk and, before proceeding to his own work, carefully perused the bank statement. This action was observed by an officer of the client company. The moral: Men must be reminded, perhaps annually, not to become complacent about leaving papers exposed, or unguarded, when they leave their desks for lunch or for other reasons. This is particularly important where financial statements and other highly confidential papers and files are involved.

Obviously, the accountant's working quarters should be such as to enjoy natural privacy. Where office space is limited, however, this is not always possible. Even where a private office is used, due care must be exercised.

The precautions to be taken by staff men should be the subject of an occasional staff bulletin and might well be commented on in staff meetings. Accountants in charge of an engagement should be expected to be alert to the possible disregard by staff members of

the safeguarding of the papers in their custody.

Bulletins to Clients Re Higher Social Security Tax Rates

Despite the newspaper publicity attendant upon the increase in social security tax rates that will become effective January 1, 1957, accountants should consider the desirability of communicating this information to certain of their clients, if not all, purely as an advisory service and as a precautionary measure. To some clients the increase may represent a substantial additional cost which, if given advance consideration, might be offset by measures within their possibilities.

The increase of 0.3% in the New York State Unemployment Insurance Tax rate, also effective January 1, 1957, as the result of a statutory situation, is another additional cost which should be brought to the attention of employers.

Personal communication of these forthcoming events is, naturally, very desirable. In any event, a bulletin to clients would be a practical preliminary step and would eliminate total neglect if the subject were not personally discussed. A staff bulletin, informing staff men as to their responsibilities in informing clients' staffs, and in checking compliance, would also be a helpful measure.



Payroll Tax Notes

Conducted by SAMUEL S. RESS

Unemployment Insurance—Merit Rating—New Definition of Qualified Employers . . . Subsidiary Taxes—Certain Employers Exempted . . . Adjustment of Benefit Factor and Quarterly Factor Allowable for Newly Eligible Young Employers for Merit Rating . . . Annual Factor in Experience Rating—Total Remuneration, Not Payroll, Used . . . Age Factor Unchanged Under the New Law . . . New Summary of Changes Enacted at the 1956 Legislative Session Available . . . "Total Unemployment"—Question of Unsalaries Corporate Officers . . . New Social Security Law Enacted—More Professionals Covered—Tax Rates Raised . . . Wage and Hour Law—New Bulletin Issued on Application of Fair Labor Standards Act to Construction Industry . . . Workmen's Compensation Premiums and Overtime Pay Records.

Unemployment Insurance—Merit Rating —New Definition of Qualified Employers

An employer who was liable during five consecutive calendar quarters, or longer, as of July 1, 1956, is a qualified employer and may earn a reduced rate if his experience and that of the fund permit it for the calendar year commencing January 1, 1957. A young firm may be eligible for a reduced rate for 1957 if the employer has been liable for contributions sometime before July 1, 1955.

Under the old law, to be qualified for a reduced rate an employer, or the employer and his predecessor must have been in the system for the $3\frac{1}{2}$ years

immediately preceding the computation date, July 1 of any year. The new definition of "qualified employer" with which practitioners should be familiar as set forth in section 581.1 (c) reads:

"(c) 'Qualified employer' means any employer whose account reflects his experience with respect to unemployment throughout not less than the four completed calendar quarters immediately preceding the computation date and who has paid some remuneration in the fiscal year immediately preceding the computation date and filed all contribution reports prescribed by the commissioner for the three fiscal years immediately preceding the computation date on or before September thirtieth next following the computation date. If an employer has paid no wages for employment in this state during a period of four consecutive fiscal years, the balance, if any, in his account shall be transferred to the general account as of the next succeeding computation date and shall not thereafter be available to such employer in the event that he resumes the payment of wages. No employer shall be a qualified employer if within the twelve consecutive calendar quarters immediately preceding the computation date any negative balance has been transferred from his employer's account as a charge to the general account pursuant to the provisions of paragraph (e) of this subdivision; or if his balance has been transferred to the general account pursuant to the provisions of this paragraph."

Paragraph (e) is another portion of the law of importance to accountants who would have their client's unem-

SAMUEL S. RESS, an Associate Member of our Society since 1936, is a member of the New York and Massachusetts Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936. He is engaged in public practice in New York City as a consultant on payroll tax problems.

Dr. Ress is a member of the Society's Committee on New York State Taxation and Chairman of the Subcommittee on Unemployment Insurance.

Payroll Tax Notes

ployment insurance accounts controlled for the purpose of keeping unemployment insurance taxes down, in the face of increasing benefit charges resulting from higher statutory benefit payments (the maximum per worker now amounts to \$936 a year), and higher wage and salary rates generally. It reads:

"(e) 'Experience rating charge' means a debit to an employer's account reflecting a payment of benefits.

"Whenever benefits are paid to a claimant, experience rating charges shall be debited to the appropriate account. The commissioner shall notify each employer currently as to each experience rating charge which is being made to his employer's account, and that shall be a determination as to the propriety of such charge and of the payment of benefits on which such charge was based. Benefits payable to any claimant with respect to his then current benefit year shall be charged, when paid, to the account of each base period employer in inverse chronological order of the claimant's most recent date of base period employment by each, at the rate of four effective days for each week of employment which the claimant had with each one of such employers in his base period. So long, however, as the claimant's last employer in his base period demonstrates that he continuously employed him to the same extent and in the same manner as during the last week in the base period in which the claimant was employed both by such last employer and by some other employer, the account of such last employer shall not be charged with benefits paid to such claimant and such experience rating charges shall be made to the account of the other employer. If all weeks of employment in the claimant's base period have been off-set by experience rating charges, benefits subsequently paid to the claimant in his current benefit year shall be charged to the general account.

"If on any computation date, an employer's account registers a negative balance, an amount equivalent to such negative balance shall be transferred as a charge to the general account, and the employer's account balance as of that day shall, be nothing." (Emphasis supplied.)

Reminder of September 30th Deadline

At this time it is most important to note that all contribution reports required for the three fiscal years immediately preceding July 1, 1956, if not already filed must be filed on or before

September 30, 1957, to prevent disqualification of an otherwise qualified employer.

Subsidiary Taxes—Certain Employers Exempted

Not all employers will be required to pay a subsidiary tax of .3% in addition to regular unemployment insurance tax rate chargeable on their taxable payrolls. The subsidiary tax should not be paid by employers who have not been in existence long enough to qualify for a reduced rate. Subsidiary contributions would apply only to employers who have been liable for contributions during at least the five completed calendar quarters ending on June 30 on which the general account percentage falls below 1.5.

Adjustment of Benefit Factor and Quarterly Factor Allowable for Newly Eligible Young Employers for Merit Rating

Provision has been made in the new law so as to permit newly eligible young employers qualified for merit rating to make certain adjustments in the computation of the quarterly and benefit factors which normally require a 3-year period for their computation. The purpose of applying the adjustment formula set forth in the new law is to serve as an equalization factor. The equalization factors which will be used is found in sections 581.1 (f) and 581.1 (h) of the law, and should be studied carefully by those accountants who wish to check the accuracy of the computation of their clients' and their own contribution merit rate for unemployment insurance.

Annual Factor In Experience Rating—Total Remuneration Not Payroll Used

Employers who have been liable for contributions for 7 or less completed calendar quarters will be assigned an

annual factor of zero. For older employers, the annual factor is no longer measured by decrease in the total payroll but by decreases of total remuneration. Such decreases are no longer established with respect to the period of 3 calendar years preceding July 1, but on the basis of decreases in the 3 fiscal years immediately preceding July 1. For employers who have been liable for contributions during 8 or more but less than 12 calendar quarters, remuneration paid during the 2 fiscal years immediately preceding the computation date is compared. Any decrease established from the earlier fiscal year to the second is divided by the total remuneration of the earlier fiscal year and the quotient obtained is multiplied by 2. The product of this multiplication constitutes the sum of quotients of annual decreases of remuneration.

Age Factor Unchanged Under the New Law

Newly covered eligible young employers will be allowed .5 for their age factor, as employers liable for contributions less than five years. The maximum age factor assigned to employers in the unemployment insurance system 13 years or more is 2.

New Summary of Changes Enacted at the 1956 Legislative Session Available

A copy of a "Summary of Changes Enacted at the 1956 Legislative Session" may be obtained by members of the Society for themselves and their staffs by written request to:

Samuel S. Ress
Payroll Tax Notes Editor of the
New York Certified Public Accountant
2488 Grand Concourse, New York 58,
New York

These two-page summaries are intended for use with the 1955-1956 edition of the Handbook For Employers that had been previously issued by the New York State Division of Employment.

"Total Unemployment"—Question of Unsalariated Corporate Officers

The Appeal Board has reversed a referee's decision in which an officer and stockholder of a corporation who renders appreciable services but draws no salary for economic reasons applied for and collected \$36 in benefits which the Industrial Commissioner seeks to reclaim. The officer-stockholder must repay the benefits collected.

In Appeal Board case number 53,995-56, it was held that the corporate stockholder and officer must repay the benefits collected to the Division of Employment. In holding for the claimant the referee took the position that the claimant's interest in the business was primarily for investment, and that her duties were sporadic and incidental to her investment even though she signed checks for the corporation. The claimant had been unemployed prior to her investment in the stock of the corporation for the sum of \$3,000, for which she had received 50% of the issued stock of the corporation and the office of vice president with the power to sign checks, none of which had been drawn to pay her any salary during the period of her alleged compensable unemployment.

New Social Security Law Enacted—More Professionals Covered — Self-Employment Tax Raised to 3⅜ % on 1957 Self-Employment Income — Employers' and Employees' Social Security Rates Each 2¼ % in 1957

More details on the recently enacted Social Security amendments of 1956 will be the subject of next month's column. Suffice it to say that the economic impact of these changes in the law, and the new direction taken (especially with regard to its new disability changes) will have far-reaching effects on all phases of present payroll fringe benefit provisions in union contracts, and outside of such agreements, too. It now appears that we can see on the horizon the coming into being, on a day-to-day basis of new payroll records that will be required for "employed"

payroll and another set for "unemployed" payroll, both being required to keep payroll costs under control.

Lawyers, all accountants, others in business for themselves—excluding only doctors and Christian Science practitioners whose exemption continues—will begin to pay the self-employment tax next April 15th.

Wage and Hour Law—New Bulletin Issued on Application of Fair Labor Standards Act to Construction Industry

Like other workers, construction workers are covered by the statutory minimum wage and overtime pay provisions if they are engaged in interstate commerce or in the production of goods for interstate commerce, including any closely related process or occupation directly essential to such production.

Among kinds of construction including even "new construction" are the maintenance, repair, reconstruction, re-designing, improvement, replacement, enlargement or extension of an instrumentality for interstate commerce or a covered production facility. Covered instrumentalities are railroads, waterways, airports, highways, city streets, telephone and pipeline systems, and transportation and communication fa-

cilities. Covered production facilities include mines, manufacturing and processing plants, power and water plants, banks, shipyards and similar establishments.

Of course, purely local construction work such as the erection, maintenance, and repair of dwellings, apartments, hotels, churches, and schools are not covered, except for those employers who regularly order or receive goods from outside the state for use on such construction projects and consequently may be covered by the law.

Workmen's Compensation Premiums and Overtime Pay Records

The accountant should check to see whether his clients in this industry, which has a high accident rate and unemployment insurance turnover, are keeping appropriate records of the overtime "premium" payment required under the wage-hour law or by union contract for two reasons:

1. To prove compliance with the law in case of investigation.
2. To save on workmen's compensation insurance costs.



facilities
d proe
plants
establish

struction
enance,
tments,
re not
employees
goods
n such
quently

ums

to see
dustry,
ce and
er, are
of the
quired
union

he law

pensa-